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Revenue Recognition, One Year Later After Release

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When the new revenue recognition rules (Topic 606) were released, every industry scrambled to determine the impact they would have on their day-to-day activities. The construction industry reviewed the language and noticed that the terminology brought other industries closer to the percentage-of-completion model already being utilized and took a collective breath. However, upon diving deeper into the language, it was determined that there were little intricacies in the new rules that could potentially materially change the financial statements. Now that we are beyond one full year of Topic 606 being implemented, we have seen many inconsistencies in the accounting treatment used in many construction company financial statements, primarily in capitalized costs to fulfill a contract, multiple performance obligations, the presentation of conditional retainage, and financial statement disclosures (footnote) presentation.

Capitalized Costs to Fulfill a Contract

One of the areas of Topic 606 that required a lot of deliberation was "capitalized costs to fulfill a contract," representing costs incurred that do not depict the transfer of value of the goods and services provided by a company to its customer. Prior to any work being performed in fulfillment of a contract, a company can incur costs for mobilization and bonding. Former revenue recognition rules allowed for the recognition of revenue based on the percentage of completion, recognizing revenue and gross profit for these costs. Under Topic 606, certain costs do not actually transfer value to the owner of the contract at that point in time, but instead transfer value to the owner of the contract over the life of the contract. Therefore, under Topic 606, costs such as mobilization and bonding incurred prior to any work being performed on the contract are required to be capitalized on a company's balance sheet and amortized back into the contract over the life of the contract, based on the percent complete. As a result of this change, the company's total revenues and costs will decrease at contract inception and increase over time, resulting in those costs being reflected as a current asset on the balance sheet. The difference in reporting under Topic 606 could create presentation and financial benchmarking issues for both a company and its third-party service providers (banks/bonding companies).

Multiple Performance Obligations

Another component of Topic 606 is the definition of a "performance obligation." If a company obtains a contract with multiple components that are separate and distinct, not highly dependent or interrelated, those components must be shown as separate performance obligations and revenue recognized on each individual obligation, rather than recorded at the entire contract level.

For example, a company has a contract with a town to build two buildings at separate ends of town. While each building is unique and distinct, the company may have one contract with two separate performance obligations. On the financial statement, revenue would be recognized on two separate profit margins depicting the transfer of the goods and services from the company to its customer for both performance obligations. Therefore, under Topic 606, revenue should be recorded at the performance obligation level, not the contract level, which will result in presentation differences between the two revenue streams earned and the related contract asset or liability adjustments.

On the other hand, if a company has a contract to construct a building and parking garage, while the two structures are distinct from each other, they are interdependent and, therefore, constitute one performance obligation.

Conditional Retainage and Contract Assets/Liabilities

A company's contract could include retainage provisions, which represent a portion of the requisitions billed by the company to be retained by the customer pending the completion of the contract (and all related terms and conditions). This amount is not currently due but will become due when certain provisions of the contract have been satisfied; this will be defined in the contract and will usually include satisfaction of certain "punch list" items, certification of occupancy and/or completion, and other inspections and requirements.

Topic 606 defines a "receivable" as being collectible over the passage of time, and, as such, retainage does not meet the definition requiring it to be classified on the balance sheet as a receivable. Therefore, under Topic 606, retainage receivable is conditional on the fulfillment of those provisions, representing a contract asset rather than a receivable. In addition, Topic 606 states that the contract asset or liability is to be presented on a contract-by-contract basis. Therefore, in an instance where a contract is either "overbilled" (contract liability) or "underbilled" (contract asset), the conditional retainage is netted against the underbilling or overbilling and included as one contract asset or liability for that contract.

For example, let's assume a company has a contract with revenue earned of $1 million and billings-to-date of $1.5 million, including conditional retainage of $300,000. Under previous revenue recognition guidance, the company would be overbilled (billings in excess of revenues) by $500,000 (current liability) and would have retainage receivable of $300,000 (current asset). Under Topic 606, the company would present one contract liability (current liability) of $200,000 representing the billings in excess net of the conditional retainage.

While the change in the presentation of conditional retainage under Topic 606 does not have an impact on a company's reported net income and overall working capital, it does adjust the presentation of contract assets and liabilities and could impact a company's debt-to-income ratios.

Financial Statement Disclosures (Footnotes)

Under previous revenue recognition rules, the normal footnote disclosures were approximately one page in length and disclosed the nature of the over/under billing amounts. Under Topic 606, the company must walk through the five steps for revenue recognition, discuss the capitalized costs to fulfill, and reflect contract assets and liabilities and contract estimates. These disclosures are now typically 3-4 pages in length to comply with Topic 606. If the company had zero impact from the items above and no numbers needed to change for financial statement purposes, at the absolute minimum the footnotes still need to be updated for the new language.

Overall Outcome

Now that the dust has settled, all extensions provided to private companies have run out, and Topic 606 has been implemented by everyone in the construction industry, we can look back and assess the outcome of the change. The first item that comes to mind is inconsistency of application and presentation, including differences in presentation by accounting firms or individual companies, due primarily to varying interpretations of the provisions of Topic 606. This inconsistency has caused issues for users of the financial statements and the ability to properly underwrite and evaluate a construction contractor. In some cases, these changes have been determined not to be material to a financial statement, leading to certain items not being properly presented and recorded. In addition, accounting software systems have not caught up with the Topic 606 changes, requiring these changes to be manually tracked by management and resulting in items missed or not properly accounted for.

A significant percentage of construction companies includes conditional retainage as part of their accounts receivable, creating additional discrepancies in the presentation of a company's financial statements that cause concern to outside users. In a normal setting, the contract asset (underbilling, a current asset) on the balance sheet is typically viewed as an unfavorable asset. With conditional retainage being taken out of retainage receivable and being shown net of contract assets and liabilities, most entities have seen a large rise in their total contract assets on the balance sheet. Therefore, without knowing what portion of that balance relates to conditional retainage, ratios performed by outside users are yielding incorrect results.

The general industry standard is that underbilling should be no more than 25 percent of total working capital. So, for example, if an entity has working capital of $25 million and underbilling of $5 million, the ratio would be 20 percent, which would be deemed acceptable. But if that same entity has $10 million of total conditional retainage, of which $8 million needs to be reclassified into contract assets, the company now has contract assets of $13 million ($5 million plus $8 million). With working capital of $25 million, outside users of the financial data would calculate an underbilling ratio of 52 percent. This would be an initial cause for concern, when in reality it is simply a change in presentation.

One strategy we've recommended to entities to address this is to disclose the amount shown within contract assets related to conditional retainage, so that users can properly calculate ratios.

Conclusion

As seen above, this small change can have a large impact on the overall presentation and review of a set of financial statements. If users of the information aren't aware of these changes, or the necessary information is not provided, incorrect outcomes could occur. Some items, such as the footnotes, are easy changes to notice; if not implemented correctly, they would cause the financial statements to not be in accordance with U.S. GAAP. In this case the entity could be at risk of losing certain financing. Conversations among the entity, CPA, and outside users should be held upfront to ensure the necessary information is shown and, if needed, to discuss the possibility of additional supplemental schedules to break down the impact.

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