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Topic 606: A Retrospective Review of Revenue from Contracts with Customers

By Christopher Sisk and Robert Mercado | Thursday, August 13, 2020

The anticipation has been building regarding implementation of the new revenue recognition standard, known as Topic 606, by private companies. Public companies have reported under Topic 606 since the beginning of 2019. For private companies, the time is now. As of January 2020, private companies became subject to Topic 606 for all entities with a year-end of Dec. 31, 2019, or subsequent. However, with the COVID-19 pandemic affecting businesses across the board, this year any company with a year-end financial statement not yet issued can defer implementation of Topic 606 until the contractors' next year end that falls after Dec. 15, 2020.

What have we learned about the impact of Topic 606, if any, on construction contractors' financial statements? The most significant impact relates to the presentation of contract assets and contract liabilities, and the disclosures associated with Topic 606. The recording of what is known as "the cost to fulfill a contract" is another area that has been affected.

PRESENTATION OF CONTRACT ASSET AND CONTRACT LIABILITY

A contract asset is defined in Topic 606 as an entity's right to consideration in exchange for goods or services the entity has transferred to a customer, conditional on something other than the passage of time.

Based on this definition, a contract asset is made up of contractor underbillings (cost and estimated earnings in excess of billings) and the retainage receivable on projects that have work left to be completed. Contract liability is defined as an entity's obligation to transfer goods or services to a customer for which the entity has received consideration from the customer, but the transfer has not yet been completed. Based on this definition, a contract liability is made up of contractor overbillings (billings in excess of costs and estimated earnings) plus any customer deposits received.

Some contractors report a specific line item for contract asset and contract liability on their balance sheets, along with disclosing in the financial statement notes the items that make up those amounts. Other contractors do the exact opposite, reporting underbillings, retainage receivable, overbillings and customer deposits on their balance sheets, and disclosing in the notes the details of what comprises a contract asset and contract liability. Both presentations are acceptable under the Topic 606 standard; however, the rationale for reporting the detail on the balance sheet, instead of the single line item of contract asset and contract liability, is how the items will be perceived by users of the financial statements. Users of the financial statements, such as the surety and financial institutions, perceive a contract asset to be only the underbillings and contract liability to be overbillings. Based on this, the user, without reading the detail disclosures in the financial statements, may misinterpret the information.

DISCLOSURE

The most noticeable change under Topic 606 was the increase in the length of financial statement footnote disclosures, specifically surrounding accounting policies relating to revenue recognition. This includes the adoption of the new standard, a description for the change in revenue recognition methodologies, disclosure of contract assets and liabilities, consideration of costs to fulfill a contract, and the financial impact of adopting the new standard. The disclosure for revenue recognition for a contractor was approximately one page under the old standard. Under the new standard, the average length is about four pages.

COST TO FULFILL A CONTRACT

The largest financial impact to construction contractors' financial statements relates mainly to the treatment of costs to fulfill a contract. These are costs incurred at the start of a project that do not transfer value to a customer. The main items that make up these costs are surety bonds, administrative set-up expenses and mobilization costs. Costs to fulfill a contract are required to be capitalized on the balance sheet and amortized to the project, based on the percent of actual cost incurred, excluding the cost to fulfill, in ratio to the estimated total cost to be incurred, excluding the cost to fulfill. Historically, these costs would be charged to the project as incurred.

Removing these costs as they are incurred at the beginning of the project, and amortizing them over the life of the project, decreases the total costs to date at the reporting period. The result is an increase in overbillings, billings in excess of costs and estimated earnings, and an overall decrease in the amount of revenue and gross profit recognized for the period. For some contractors, this could be a significant change in the amount of revenue and gross profit recognized as of the reporting date.

SUMMARY

Originally, the impact of the new revenue recognition standard for contractors was anticipated to be significant; ultimately, for most contractors, the impact wasn't significant at all. For the most part, contractors were able to present their financial statements consistent with how they were reported under the old standard, with the exception of additional disclosure.

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