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Understanding the Impacts of Implementing Topic 606

By Robert Mercado and Taryn Smith | Wednesday, October 7, 2020

Tax , Finance , Accounting

Construction contractors have started implementing Topic 606, the new revenue recognition standard. This practice has proven to have significant impacts on contractors' financial statements relative to the old reporting method. Areas most affected are timing of revenue and gross profit. In turn, these have also significantly altered the comparison of financial reporting to tax reporting. The two most common factors that have changed revenue recognition in financial reporting are:

1. multiple performance obligations; and
2. capitalization of costs to fulfill.

MULTIPLE PERFORMANCE OBLIGATIONS

Performance obligation is defined as a promise (explicit or implicit) to transfer a distinct good or service (or a bundle of distinct goods and services). For financial reporting, a contractor must determine if a contract has multiple performance obligations. If so, the contractor required to calculate the revenue recognized based on percentage of completion using the cost-to-cost method on each performance obligation in lieu of basing the calculation on the contract as a whole. In certain circumstances, this may impact the revenue recognized and gross profit earned.

In tax reporting for contractors required to use the percentage of completion method, revenue is recognized at the contract level, not at the performance obligation level. This yields a difference between financial reporting and tax reporting calculations. The following is an example of how a contract for financial reporting purposes is reported based on the performance obligations as compared to the tax reporting at the contract level.

	Total Contract			From Inception to December 31, 2019					
Description	**Total Contract Price**	**Estimated Cost of Revenues**	**Estimated Gross Profit**	**Contract Revenue**	**Costs of Revenues Earned**	**Gross Profit**	**Billing To Date**	**Estimated Costs to Complete**	**Percent Complete**
Financial Reporting at the Performance Obligation level									
Contract A									
Building 1	$ 15,000,000	$ 12,750,000	$ 2,250,000	$ 10,000,000	$ 8,500,000	$ 1,500,000	$ 10,100,000	$ 4,250,000	66.67%
Building 2	12,750,000	10,200,000	2,550,000	9,375,000	7,500,000	1,875,000	9,300,000	2,700,000	73.53%
Total Glass Contract	27,750,000	22,950,000	4,800,000	19,375,000	16,000,000	3,375,000	19,400,000	6,950,000	69.72%
Tax Reporting at the Contract Level									
Contract A	27,750,000	22,950,000	4,800,000	19,346,405	16,000,000	3,346,405	19,400,000	6,950,000	69.72%
Difference	$ -	$ -	$ -	$ 28,595	$ -	$ 28,595	$ -	$ -	

The financial reporting in this one example provides for $28,595 of additional revenue and gross profit earned, as compared to the tax reporting.

CAPITALIZATION OF COSTS TO FULFILL

Certain costs contractors incur are required to be capitalized on the balance sheet for financial reporting purposes and expensed to a project over time based on the percent complete. These costs are known as “costs to fulfill.” A cost would be considered a cost to fulfill if it meets the following three criteria.

1. Cost relates directly to a contract or to an anticipated contract that the entity can specifically identify.
2. Cost generates or enhances resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future.
3. Cost is expected to be recovered.

For example, mobilization to a jobsite would meet the above criteria. Even though the contractor is able to requisition for the expenses related to this, the contractor is required to capitalize as an asset on the balance sheet the cost incurred related to the mobilization on the project, and expense the cost to the project based on the percent complete. The percent complete is calculated with the amount of the cost of mobilization removed from the estimated total cost of the project.

For tax reporting purposes, these costs to fulfill are required to be expensed to the project as incurred. The following is an example comparing financial reporting and tax reporting.

- A contractor entered into a $30 million contract. As of Dec. 31, 20XX, the contractor had incurred $1 million of mobilization costs in addition to incurring $3.5 million of cost related to work performed on the contract.
- The contractor expensed a portion of the mobilization costs to the contract based on the percent complete without the mobilization cost in the estimated cost of revenue earned and costs of revenue earned. (Percent complete without mobilization costs is calculated as follows: $25,500,000- $1,000,000 / $4,500,000 - $1,000,000 = 14.28%.) (The amount expensed to the project based on the percent completed without mobilization costs is calculated as follows: $1,000,000 X 14.28% = 142,800.)

	Total Contract			From Inception to December 31, 2019				
Description	Total Contract Price	Estimated Cost of Revenues	Estimated Gross Profit	Contract Revenue	Costs of Revenues Earned	Gross Profit	Billing To Date	Estimated Costs to Complete
Financial Reporting with Costs to Fulfull Based on Percent Complete								
Interstate Highway Project	$ 30,000,000	$ 25,500,000	$ 4,500,000	$ 4,285,647	$ 3,642,800	$ 642,847	$ 6,000,000	$ 21,857,200
Tax Reporting Based on all Costs Incurred Charged to Project								
Interstate Highway Project	30,000,000	25,500,000	4,500,000	5,294,118	4,500,000	794,118	6,000,000	21,000,000
Difference	$ -	$ -	$ -	$ (1,008,471)	$ (857,200)	$ (151,271)	$ -	$ 857,200

As shown in the above example, the revenue earned, costs of revenue earned, and gross profit could vary significantly when comparing the financial reporting to the tax reporting.

CONCLUSION

Each contractor is different and therefore affected differently by the provisions in Topic 606. The above examples illustrate the most significant impacts that presented during the implementation process of Topic 606. Also demonstrated is that tax reporting does not necessarily align with financial reporting under the new rules. Understanding the ramifications of Topic 606 and the differences between the varying financial reporting and tax rules is imperative. Being well versed and prepared allows financial reporting and tax reporting to occur with minimal impact and fewer surprises.

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