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Significant Impacts of Revenue Recognition Under New Topic 606

By James Wiedemann and Robert Mercado | Thursday, May 27, 2021

Since 2014, contractors have heard about the new revenue recognition standard known as Topic 606. The new standard originally was required to be implemented by non-public companies with fiscal years beginning after Dec. 15, 2018, but due to the pandemic, implementation was deferred to years beginning after Dec. 15, 2019.

Many contractors and their accountants are still working to understand all of the rules of the new standard and how they are applied. For some contractors, Topic 606 has had little to no impact on the revenue recognized compared to the old standard; however, for other contractors, there is a significant impact in the amount of revenue recognized.

MASTER SERVICE AGREEMENTS

Master service agreements (MSA) are entered into by contractors to establish the framework for work to be performed. The MSA establishes the overall agreement on pricing and other contract terms. Under the old standard, an MSA was considered to be the contract with the customer and recorded as such. Under Topic 606, an MSA is not considered a contract because it does not specify the actual work to be performed. Each task order issued under the MSA is considered a separate contract.

For example, an electrical contractor is awarded an MSA to replace street lights over a period of two years. This is not a contract under Topic 606 because the contractor does not have a specific work order that states which lights will be replaced. Once a light is selected for replacement, that task order becomes a contract. This new procedure is a significant change for some contractors.

CONTRACT COST

To recognize revenue, cost must be incurred. Any change to the way cost is recognized will have an impact on the revenue recognized. One of the largest obstacles to the implementation of Topic 606 has been the ability to track certain contract costs incurred by contractors on a project that, under Topic 606, are accounted for differently than under the old standard. The most significant change in the recognition of cost is capitalized costs to fulfill. Currently, most accounting systems don’t have the ability to properly capture these costs based on Topic 606. Contractors must address these costs outside of their accounting systems, which makes it more difficult to account for contract costs properly.

CAPITALIZED COSTS TO FULFILL

Costs incurred at the start of a project that do not transfer value to a customer and have an impact of the entire project are considered costs to fulfill a contract. Examples of these costs are surety bonds, administrative setup costs and mobilization. Although these costs are requisitioned to a customer, the cost incurred for these items are required to be capitalized on the balance sheet instead of recorded as job cost on the project.

These costs are then allocated to each project based on the percent complete of the contract from a cost-to-cost perspective, exclusive of the capitalized costs to fulfill. That is, in the calculation of the percent complete, to allocate the capitalized costs, the actual cost and estimated total cost on the contract are reduced by the total cost to fulfill to compute the actual percent complete on a project minus the costs to fulfill. Once the percent of complete excluding costs to fulfill is calculated, the percent complete is then multiplied by the total costs to fulfill on that contract to determine the amount that will be allocated to the contract at that point in time and included in the calculation of revenue recognized.

As an example, assume a contractor incurs a cost of $6 million as of Dec. 31, 2021, of which $1 million consists of costs to fulfill. The total estimated cost on this project is $11 million. To determine the amount that will be included in the percentage of completion to recognize revenue and gross profit, the contractor would calculate the percent complete exclusive of the cost to fulfill (($6,000,000 - $1,000,000)/($11,000,000 - $1,000,000)). This would equate to 50% complete. The 50% complete multiplied by the cost to fulfill of $1 million would result in $500,000 charged against the project and included in the recognition of revenue. The other $500,000 would be capitalized on the balance sheet as an asset.

Based on the cost applied to the project, which is lower than the cost that would have been computed under the old standard, Topic 606 could have a significant impact on a contractor’s revenue and gross profit recognized on a contract at a point in time.

CONTRACT ASSET AND CONTRACT LIABILITY

Another significant change is new terminology introduced in Topic 606: contract asset and contract liability. A contract asset is defined as an entity's right to payment for goods and services already transferred to a customer if that right to payment is conditional on something other than the passage of time. A contract liability is defined as is an entity's obligation to transfer goods or services to a customer when the customer prepays consideration or when the customer's consideration is due for goods and services that the entity will yet provide, whichever happens earlier.

There has been confusion on what is considered a contract asset and what is considered a contract liability. To simplify, contract assets on the balance sheet are specific adjustments to revenue and are contingent on something other than the passage of time. Contract liabilities on the balance sheet are specific adjustments to revenue only.

The following items would be considered a contract asset or liability on the balance sheet:

- Under-billing on a project;
- Unbilled receivable;
- Conditional retainage (formerly included in contracts receivable);
- Over-billing on a project; and
- Customer deposits.

Conditional retainage refers to amounts that have been included on a requisition to a customer that are contingent on the completion of work. Under Topic 606, this retainage can no longer be included in contracts receivable on the balance sheet. Once work is completed and retainage is released by the customer, allowing only for the passage of time for the retainage to be paid, it is moved from conditional status to retainage receivable.

Capitalized costs to fulfill and retainage payable are not considered contract assets or liabilities. These accounts do not go directly to revenue; they are strictly cost-related items.

It’s also important to note that each contract can have only one contract asset or liability; it can’t have both. As a result, if a contract is over-billed but also has conditional retainage, the contract liability must be reduced by the conditional retainage to net the contract asset and liability by contract.

CONCLUSION

While the new revenue recognition standard has not impacted some contractors, it has impacted others. Understanding the new standard is essential to understand how it will impact the contractor’s financial statements.

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