How to Apply New Revenue Recognition Rules to Your Construction Company

by Dana L. Kotarba
Executive summary

New Revenue Recognition Standard ASU 2014-09 is effective for reporting periods beginning after December 15, 2018 (calendar year 2019 for private companies).

Revenue and profit recognition requirements are changing but, overall, the methodology historically used by contractors will be consistent except for a few key differences in the following areas:

- Change orders and claims
- Identification of performance obligations
- Uninstalled materials
- Certain contract costs (incremental and fulfillment costs)

New disclosures will be required in financial statements.

Simplifying the revenue recognition process

In 2014, the Financial Accounting Standards Board (FASB) released sweeping new guidance that covers all companies filing under Generally Accepted Accounting Principles (GAAP or U.S. GAAP). ASU 2014-09, Revenue from Contracts with Customers represents one of the most significant revisions to GAAP in its history and will have a significant impact on contractors.

While it would seem that moving from a rules-based approach to a principles-based approach would simplify the revenue recognition process, the new guidance and supporting information released in ASU 2014-09 is more than 700 pages long. The American Institute of Certified Public Accountants (AICPA) has created a task force to specifically address implementation issues of ASC 606 by contractors. This group will be updating the widely used audit and accounting guides for contractors, as well as providing specific implementation guidance for the industry.

This whitepaper offers information specifically related to construction contractors.

What prompted this change?

Revenue recognition has evolved into a complex and confusing patchwork of different rules and requirements that have been inconsistently applied from industry to industry. With these new rules, the FASB has taken a clean-slate approach and developed a principles-based approach that will be applicable to companies in all industries. The new standard is intended to remove inconsistencies and weaknesses in existing requirements. Its enhanced disclosure requirements will also provide more useful information for users of financial statements.

New rules apply to all contracts to provide goods or services

These new rules apply to all contracts to provide goods or services in the ordinary course of business. This includes the sale of some non-financial assets such as fixed assets and intangible assets that are not part of a company’s ordinary course of business. The guidance excludes lease contracts, insurance contracts, financial instruments, guarantees, and certain nonmonetary exchanges.

Effective date for new rules

For private companies, the effective date is for annual reporting periods beginning after December 15, 2018 (2019 for calendar-year companies). Early adoption is permitted for annual reporting periods beginning after December 15, 2017.

For public companies, the effective date is for annual and interim reporting periods beginning after December 15, 2017, and no early adoption is permitted.

Two transition methods

The new guidance allows companies to select between two transition methods: the full retrospective or the simplified approach.

Full retrospective method

Using the full retrospective method, a company would restate all periods presented as if they had been accounted for under ASC Topic 606 originally. Comparative periods would be restated.

Retrospective application with a cumulative effect adjustment (simplified approach)

Using the simplified approach, a company can elect to apply ASC Topic 606 only to contracts that are in progress at the
date of initial application (for example, January 1, 2018, for private companies with a calendar year-end) and new contracts going forward. The cumulative adjustment to the opening balance sheet will be reflected in retained earnings. Disclosures in the financial statements will be required to explain the differences in each financial statement line item resulting from the adoption of the new guidance. Comparative periods would not need to be restated.

Choosing a transition method
Contractors will need to examine their contracts and determine which method above will be the best approach. Contractors who conclude that no significant changes in revenue recognition for their contracts will be necessary under the new standard may consider either method above. Contractors who expect many changes in revenue recognition may consider the retrospective method, as this is the simplified approach.

Five-step process
The core principle of the new guidance is that entities should recognize revenue “to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”

The FASB outlines a five-step process to apply this principle:

**Step One: Identify the contract(s) with a customer.**

**Step Two: Identify separate performance obligations in the contract.**

**Step Three: Determine the transaction price.**

**Step Four: Allocate the transaction price to the performance obligations in the contract.**

**Step Five: Recognize revenue when (or as) the reporting organization satisfies a performance obligation.**

Areas of concern for contractors
Construction contractors are already asking some important questions, including:

- Did percentage of completion go away?
- Can you recognize profit on uninstalled materials?
- Will most contracts have multiple performance obligations?
- Is cost-to-cost still valid in determining progress towards completion?
- Will there be costs or billings in excess?
- How are change orders and claims accounted for?
- How many additional disclosures will be required?

Step-by-step guidance
The FASB’s five-step process attempts to make the changes as understandable as possible. Still, we provide commentary and examples to help clarify the new rules.

**Step One: Identify the contract(s) with a customer**
According to the FASB, a contract exists if the following are true:

- The contract has commercial substance.
- The contract has been approved by the parties to the contract, and the parties are committed to satisfying their obligations.
- The contract has enforceable rights regarding goods or services to be transferred.
- There are identifiable payment terms (even if amount is uncertain).
- It is probable that the entity providing goods or services will collect what is expected to be received in exchange for those goods or services that will be transferred to the customer.

For construction contractors, entering into a written contract with a customer typically achieves the five criteria above.

**Step Two: Identify separate performance obligations in the contract**
The new standard requires companies to determine the performance obligations in each contract. A performance obligation is a promise to deliver a good or provide a service (or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer). In order to identify performance obligations in each contract, a company needs to determine whether or not the goods or services are distinct. If distinct, a customer can benefit from the good or service on its own (the good or service is separable from the other goods or services in a contract). A good or service is not distinct if:

- It is highly interdependent and interrelated.
- It significantly modifies or customizes other goods and services in a contract.
- The company provides a significant integration service.

Determining the distinct nature of goods and services will require judgment. ASC 606-10-25-21 provides a list of factors for the contractor to consider when determining whether there are separate, distinct goods or services in a contract. The contractor will need to evaluate each contract to determine whether there is more than one performance obligation.
In our experience, the majority of construction contracts provide goods or services that are highly interdependent and interrelated, which would be considered one performance obligation.

**Example:**
A contractor enters into a contract to design and build a hospital. The contractor is responsible for the design and management of the project, including engineering, construction of offices, patient rooms, a cafeteria, lab space, and waiting rooms. The contractor concludes that these goods are interdependent and interrelated (the customer cannot benefit from each good on its own), so the contract would be considered one performance obligation.

Another example of a contract that would likely have only one performance obligation would be a service contract that requires the same good or service to be performed consecutively over a period of time.

An example of a contract that would have more than one performance obligation would be a contract to construct a building and perform maintenance on the building once it has been completed. The construction of the building and the maintenance of the building are two separate and distinct services, which would require two performance obligations.

### Step Three: Determining the transaction price

The transaction price is the amount a contractor expects in exchange for satisfying its performance obligation.

For contractors, the transaction price is typically the contract price in a contract. However, what happens when there is a change in the contract value (change orders), claims, or other incentives or awards that are unknown at contract inception?

### Contract modifications

Change orders are accounted for differently depending on whether they are considered distinct from the original contract. Here are two potential scenarios:

1) If a change order is distinct and has a stand-alone price, it is considered a new contract and accounted for as a separate performance obligation.

2) If a change order is the continuation of the contract, and the goods or services are not distinct from the existing contract, the contract is accounted for as a cumulative catch up as if the change order had been in place from the inception of the contract.

Keep in mind that in order for the contract price to reflect the amount of a change order, the parties need to have approved the change order, either in writing, orally, or implied by customary business practices. If the parties to the contract have not approved the change order, the contractor should not include the amount of the change order in the contract price.

### How is this different from current GAAP?

Under current GAAP, change orders are typically added to the value of the overall contract, along with the additional estimated costs to complete, similar to scenario two described above. Gross profit recognized is based upon the revised percentage of completion.

### Variable consideration

One of the significant changes under the new standard is the introduction of variable consideration. Variable consideration requires management to estimate pricing if a formal change order has not been finalized (unpriced change order). Under the new standard, a contractor will need to use probabilities related to change orders to determine whether, and how much of, the change order should be added to the contract. In many cases, this could allow recognition of claims revenue and unapproved change orders that would not have been allowable under the old guidance.

Variable consideration is accounted for using either the expected value approach, or the most likely amount approach.

The method used depends on which one is the best predictor of the amount the contractor will receive. Contractors should utilize all information (history with customers, current information, and forecasted information) when estimating variable consideration.

The expected value approach is the expected amount in a range of values. This usually arises during change order or claim situations. In these cases, the contractor should evaluate, based on prior experience, what it believes the outcome will be.
Example:
If a claim is $3 million, but the contractor believes it will receive $2 million based on prior knowledge, the transaction price can be increased by $2 million.

The most likely amount approach can also be called the “all or nothing” approach.

Example:
If the contract terms offer a $5 million incentive for early completion, the contractor must determine whether it is possible to complete the contract early or not. The contractor should base its determination on past experience with similar contracts. It is likely that a contractor will not know whether it will meet the incentive requirements until later on during the contract.

The new standard stresses the following: Amounts are only included in the contract price if it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur in the future.

Step Five: Recognize revenue when (or as) performance obligations are satisfied
Under the new standard, revenue is recognized upon the satisfaction of performance obligations, which occurs when control of the good or service transfers to the customer. The transfer of control can occur over time or at a point in time.

In the construction industry, control is often transferred over time. Under the new standard, control is transferred over time when at least one of the following criteria is met:

- A customer receives and consumes the benefits of the contractor’s performance as the contractor performs it.
- A contractor’s performance creates or enhances a customer-controlled asset.
- An asset with an alternative use to the contractor is not created, but the contractor has a right to payment for performance completed to date.

A performance obligation is satisfied at a point in time if it does not meet the criteria above.

Under the new standard, measuring progress towards completion is performed using either the input or output method:

Input method
The input method recognizes revenue on the basis of the contractor’s efforts or inputs to the satisfaction of a performance obligation, such as labor hours, labor dollars, machine hours, costs incurred, or material quantities used, relative to the total expected inputs to the satisfaction of that performance obligation.

Costs incurred related to rework (labor inefficiencies) or wasted or defective materials are excluded from input measurement because these costs do not represent the transfer of goods or services to the customer and do not contribute towards project completion.

This concept could vary widely in how it is applied in practice, and could cause inaccurate reporting of costs incurred towards completion.

Output method
The output method recognizes revenue on the basis of direct measurement of the value to the customer of goods or services transferred to date relative to the remaining goods or services promised under the contract. Examples include: surveys of goods or services transferred to date, appraisals of results achieved, milestones reached, or units produced or delivered.
For construction contractors, the majority of performance obligations will be measured over time as control is transferred using the input method. This is consistent with the **percentage of completion method** under the existing standards.

Certain service and maintenance contracts may include variable consideration, such as incentive provisions and milestone achievements. These contract provisions will need to be evaluated to determine how performance obligations are satisfied and which method for recognizing revenue should be used.

**Recognizing revenue for uninstalled materials**

In some cases, contracts may have a significant amount of uninstalled materials for which control has not been transferred to the customer. Costs related to these uninstalled materials should be excluded from the contract because they don’t represent contract progress. These materials should be accounted for on the balance sheet as an inventory asset. Once the customer obtains control of the materials, revenue is recognized equal to the cost of goods transferred. The uninstalled materials guidance is currently being evaluated, and further guidance will be forthcoming.

**Contract costs**

The new standard identifies two types of costs that may need to be capitalized: incremental costs and contract fulfillment costs.

Incremental costs are the costs of obtaining a contract that a contractor would not have incurred if the contract had not been obtained. Examples include sales commissions and costs incurred during proposal, negotiation, and design phases. These costs are recognized as assets if they are expected to be recovered and are amortized as control of goods or services to which the asset relates is transferred to the customer. If the amortization period is less than one year, these costs may be expensed as incurred (included in job costs). Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained (e.g., certain bid costs) would be expensed as incurred unless the contract explicitly states they are chargeable to the customer.

Contract fulfillment costs are costs that could be considered fixed assets, inventory, or intangible assets. If not able to capitalize under other GAAP rules, fulfillment costs should only be capitalized if the following criteria exist:

- Costs are directly related to a specific contract.
- Costs relate to future performance.
- Costs are recoverable.

Examples of contract fulfillment costs could be insurance and bonding or mobilization cost. Costs are amortized to contract costs as control of the goods or services is transferred. For contractors, amortization will most likely be evenly spread over the estimated contract duration.

Even though fulfillment costs are reported on the balance sheet and amortized to contract costs, the contactor needs to ensure that these costs are considered as part of total contract costs when analyzing overall profitability of a contract.

**Other items to consider**

**Warranties**

Estimates of future warranty costs shall be considered in cost-to-cost input calculation. There could be cases where significant warranties could be considered separate performance obligations.

**Noncash consideration**

If a customer contributes labor, materials, or equipment in fulfillment of a contract, the value of the goods or services received should be valued at fair value and included in the contract price if the contractor obtains control of the contributed goods or services. These situations commonly
arise in the construction industry when an owner purchases materials directly, for example, to take advantage of sales tax exemptions. Other considerations, such as time value of money, should be evaluated.

**Disclosure requirements**
The new standard continues the FASB’s recent trend of providing private reporting companies with a reduced set of disclosure requirements (compared to what is required for publicly held companies). Some of the new disclosure requirements for private companies include:

- Revenue disaggregated according to the timing of transfer of goods or services (at a point in time as well as over time) and qualitative information about how economic factors (such as type of customer, geographical location of customers, and type of contract) affect the nature, amount, timing, and uncertainty of revenue and cash flows
- The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed
- Information about performance obligations, including a description of all of the following:
  - When the entity typically satisfies its performance obligations
  - Significant payment terms
  - The nature of the goods or services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services
  - Obligations for returns, refunds, and other similar obligations
  - Warranties and related obligations

**CliftonLarsonAllen can help**
Correctly implementing the new standard is a substantial undertaking for contractors. Applying the new guidance may require discussions about current contracts as well as financial disclosures. CLIFTONLARSONALLEN can help you and your company navigate these changes so that your financial statements are accurate and easy to understand for the professionals who use them. For more information on the new revenue recognition standards, contact Dana Kotarba at dana.kotarba@claconnect.com or 925-943-1776.