REVENUE RECOGNITION

The newly effective revenue recognition standards aim to establish principles for reporting useful information to financial statement users, and they will likely have an effect on contractors.

MIKE KARLINS

Revenue is one of the most important financial measurements used in assessing an entity's performance. Guidance for revenue recognition has differed between U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards (IFRS). For approximately 10 years, GAAP and IFRS were moving toward becoming identical. This process eventually ceased, although GAAP continued to transition revenue recognition to align more closely with IFRS.

Until December 31, 2018, GAAP for private companies had detailed, complex, and disparate revenue recognition requirements for each industry (e.g., construction, health care, and software). In 2014, new accounting standards were issued for recognizing revenue from contracts with customers. The objective of this new standard was to establish principles for reporting useful information to readers of financial statements.

Effective as of January 1, 2019, the new revenue recognition standard for private companies, Accounting Standards Codification (ASC) 606-10-25-1, will require construction contractors to make additional judgments regarding when to recognize revenue associated with their contracts. The core principle in recognizing revenue is 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.

Identifying contracts with customers

ASC 606 provides five criteria that must be met for an agreement to be identified as a contract:

1. Approval and commitment of the parties: The commitment must be legally

MIKE KARLINS *is a certified public accountant and audit partner with Calvetti Ferguson, PC, an accounting and advisory firm based in Houston, Texas. He is the secretary/treasurer for Construction Industry CPAs/Consultants Association and is on the tax and legislative committee for the Construction Financial Management Association. With more than 30 years of experience working with real estate and construction companies, he is uniquely positioned to provide clients with a level of service they should expect from their CPA firm. His clients include general contractors, specialty subcontractors, utility contractors, real estate developers, and service organizations.*

enforceable and can be written, oral, or implied. Certain termination clauses may demonstrate a lack of commitment.
2. Identification of the rights of the parties: The goods and services associated with the contract must be identified.
3. Identification of the payment terms: Terms are not required to be fixed or stated, but they must be determined and enforceable.
4. Commercial substance: The risk, timing, and the amount of the entities' future cash flows must be impacted by the execution of the contract.
5. Probable collection of payment: The customer is able and intends to pay the contract consideration.

Assessing multiple performance obligations

The determination of the various performance obligations in contracts with customers requires a great deal of analysis and judgment on the contractor's part. After identifying the contract, an entity will evaluate the contract terms and its customary business practices to identify all promised goods and services within the contract and determine which of the promised goods and services (or bundled goods and services) should be accounted for as separate performance obligations. The revenue standard identifies several activities common to engineering and construction entities that are considered promised goods and services, including the construction, manufacture, or development of an asset on behalf of a customer and performance of a contractually agreed-upon task for a customer.

The criteria in the new revenue standard for identifying performance obligations differ from the contract segmentation guidance of ASC 605-35, which could result in different conclusions about the units of account. Previously, for example, a contractor may have considered an entire contract to be a profit center, but, under the new standard, it may determine the contract contains two or more performance obligations (promises) that would be accounted for separately. These judgments may be more complex when, for example, a construction contract also includes design, engineering, or procurement services.

According to ASC 606-10-25 and its subparts, promised goods and services represent separate performance obligations if (1) the goods or services are distinct (by themselves or as part of a bundle of goods and services) or (2) the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

Determining whether goods and services are distinct involves a significant degree of judgment based on the facts and circumstances of a given contract. According to ASC 606-10-25-19, goods and services are distinct if *both* of the following are met:
1. The customer can benefit from the goods and services on their own or with other readily available resources (capable of being distinct).
2. The contractor's promise to transfer goods and services is separately identifiable from other promises in the contract (distinct in the context of the contract).

Series of performance obligations

The new guidance (ASC 606-10-25-14) indicates that a contractor should assess goods or services promised in a contract and identify as performance obligations each promise to transfer to the customer either:
1. a good or service (or bundle of goods or services) that is distinct or
2 a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

The standard (ASC 606-10-25-15) indicates that a series of distinct goods or services has the same pattern of transfer to a customer if both the following criteria are met:
1. Each distinct good or service in the series that the entity promises to transfer to the customer would be criteria of a performance obligation satisfied over time.
2. In accordance with paragraphs 31–32 of ASC 606-10-25, the same method would be used to measure the entity's progress toward complete satisfaction

THE DETERMINATION OF THE VARIOUS PERFORMANCE OBLIGATIONS IN CONTRACTS WITH CUSTOMERS REQUIRES A GREAT DEAL OF ANALYSIS AND JUDGMENT ON THE CONTRACTOR'S PART.

of the performance obligation to transfer each distinct good or service in the series to the customer.

In the construction industry, an example of a contract that includes a series of goods or services to be provided to the customer may be a landscaping contractor who has a contract to install and maintain a lawn, gardens, and other landscaping features at a school. The maintenance portion includes provisions to maintain the landscaping and provide snow removal and mowing over a three-year term.

In this example, the contractor would need to assess the distinct performance obligations that existed. When evaluating the maintenance portion of the contract, the contractor would need to assess whether the services were not highly integrated with or highly dependent on the construction services to determine if the maintenance services were a separate performance obligation.

Additionally, assuming the landscaper determined a separate performance obligation existed, he or she would need to determine if the maintenance portion of the contract included one or more performance obligations and if any of those performance obligations was a series of goods and services with the same pattern of delivery. Depending on the terms of the contract, garden maintenance may not be considered a series of distinct goods and services with the same pattern of transfer, but it would be highly likely that mowing services would be a series of services that are substantially the same with the same pattern of transfer to the customer.

AN ENTITY SHOULD INCLUDE IN THE TRANSACTION PRICE SOME OR ALL OF THE VARIABLE CONSIDERATION AMOUNT ESTIMATED IN ACCORDANCE WITH ASC 606-10-32-8 ONLY TO THE EXTENT THAT IT IS PROBABLE THAT A SIGNIFICANT REVERSAL IN THE AMOUNT OF CUMULATIVE REVENUE RECOGNIZED WILL NOT OCCUR WHEN THE UNCERTAINTY ASSOCIATED WITH THE VARIABLE CONSIDERATION IS SUBSEQUENTLY RESOLVED.

Evaluating variable considerations

A significant change included in the new revenue recognition standard, *Revenue from Contracts with Customers (Topic 606)*, is the treatment of variable consideration. This change will likely impact every contractor.

The new standard requires an entity to estimate variable consideration and apply the constraint in determining the transaction price rather than assessing whether the amount is fixed or determinable. This may result in earlier revenue recognition in a number of circumstances.

The following are examples of variable considerations within a contract:

- claims and pending change orders;
- unpriced change orders;
- incentive and penalty provisions within the contract;
- shared savings;
- price concessions;
- liquidating damages; and
- unit price contracts with variable units.

The contractor is required to evaluate whether to constrain amounts of variable consideration included in the transaction price. The objective of the constraint is to include variable consideration in the transaction price only to the extent it is probable that a significant revenue reversal will not occur when uncertainty is subsequently resolved.

After estimating the transaction price, an entity is required to evaluate the likelihood and magnitude of a reversal of revenue due to a subsequent change in the estimate. ASC 606-10-32-11 discusses when to include variable consideration in the transaction price and notes that an entity should include in the transaction price some or all of the variable consideration amount estimated in accordance with ASC 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. Note that the "significance" of a reversal is measured against cumulative revenue recognized to date on the performance obligation and is not a financial materiality measure.

Uninstalled materials

Determining the amount and timing of revenue recognition as costs are incurred for uninstalled materials using a cost-to-cost input method under ASC 606 requires significant judgment by the contractor based on the facts and circumstances present in a given contract.

ASC 606 guidance is secondary to other GAAP guidance. Accordingly, the first requirement regarding uninstalled materials is to determine if they meet the requirement of classification as inventory. If so, then inventory should be recorded, and the item is treated as a contract cost only after customary inventory transfer accounting.

If costs including uninstalled materials, wasted resources, or inefficiencies are not proportionate to progress in satisfying the performance obligation, an entity must carve out these costs when using a cost-to-cost input method. For example, a faithful depiction of performance might be to recognize zero profit if, at contract inception, the contractor expects (as per ASC 606-10-55-21(b)) all of the following conditions to be met:

1. The equipment or materials are not distinct.
2. The customer is expected to obtain control of the equipment or materials significantly before receiving services related to the equipment or materials.
3. The cost of the transferred equipment or materials is significant to the total expected costs to completely satisfy the performance obligation.
4. The contractor procures the equipment or materials from a third party and is not significantly involved in designing and manufacturing the equipment (but the contractor is acting as a principal).

The "at contract inception" condition in this example is not intended to suggest that assessment of uninstalled materials should only be performed based on facts that exist at contract inception. If the conditions listed exist at any time during the performance of the contract, the impact should be evaluated.

The determination of whether the cost of uninstalled materials are significant is a judgment. While there is no specific GAAP guidance on this topic, construction industry accounting experts have suggested that 15 percent or more might be appropriate thresholds.

Recognizing revenue

When performance obligations are to be recognized over time, an appropriate driver should be selected to measure the progress of transferring control to the customer. Again, judgment will be required in this selection and should be based on the nature of the contract. Both input and output methods are generally acceptable as long as they appropriately measure the transfer of control of goods or services to the customer. Once a method of recognition is selected for a certain performance obligation, it must be used until the performance obligation is satisfied. Changing methods is not allowed.

Output methods, such as time lapsed; units produced, surveyed, or appraised results; or milestones reached may be preferable if they accurately measure the progress in transfer of control to the customer. However, these methods must be reliably and consistently measured throughout the performance of the contract.

Input methods used to recognize revenue such as cost incurred, resources consumed, labor hours utilized, and time elapsed relative to the estimated total inputs are acceptable under ASC 606. Absent an identified input or output method that better measures progress, the construction industry can continue to use cost incurred to total estimated cost, which is often used in current percentage of completion accounting. It is important to note that the use of the cost-to-cost method is not a free election but rather can be utilized only if it results in a reasonably accurate approximation of transfer of control to the customer. If control is not ratably transferred, cost-to-cost may not be a satisfactory measure.

Under ASC 606, revenue is measured and not gross profit. In selecting the most appropriate measure, the entity should focus only on revenue. Previously, under GAAP, some specialty contractors may have used labor as an appropriate measure of recognition of gross profit. However, under ASC 606, labor may not be an appropriate proxy to measure revenue.

Fulfillment costs

Certain costs to fulfill contracts are to be capitalized on the balance sheet. The contractor must first determine whether the costs are addressed by other standards (i.e., inventory) and, if so, apply that guidance. The contractor should amortize a capitalized contract fulfillment cost to job costs over the period reflecting the transfer of control to the customer, which, in most cases, will be the expected duration of the contract

WHEN PERFORMANCE OBLIGATIONS ARE TO BE RECOGNIZED OVER TIME, AN APPROPRIATE DRIVER SHOULD BE SELECTED TO MEASURE THE PROGRESS OF TRANSFERRING CONTROL TO THE CUSTOMER.

for a construction contract containing a single performance obligation.

The general guidance for identifying fulfillment costs are that the costs must:

1. relate directly to a contract or an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
2. generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
3. expect to be recovered.

Costs to fulfill a contract that are incurred prior to the transfer of control to the customer (or that do not result in the transfer of a service or product to the customer) are subject to review for capitalization.

Therefore, if a contract with a customer will transfer control at completion of a service, the costs incurred in fulfilling the contract would be capitalized under this guidance if not required by other guidance. On the other hand, if the cost incurred results in or is part of the transfer of control to the customer, the cost is recognized as a contract cost in measuring performance for revenue recognition.

Capitalized costs to obtain a contract

Incremental costs of obtaining a contract are costs that the contractor would not have incurred if the contract had not been awarded to the contractor. These costs are to be capitalized on the balance sheet and then amortized on a basis consistent with the transfer of the goods or services to which the amounts relate. Note that the unamortized costs are to be evaluated for impairment.

The word to focus on is "incremental." A typical (and almost exclusive) cost that a construction entity will incur that is considered an incremental cost to obtain a contract is a sales commission. The key is that, to be a transaction of this type, the cost would not be incurred if the contract were not obtained (not when the contract is pursued).

Imagine a contractor incurs the following costs in order to obtain a construction project. The contractor expects to recover all the costs incurred in order to obtain the contract.

Travel costs to deliver bid proposal	$10,000
Commissions paid to the salesperson	5,000
Total	$15,000

The contractor should only capitalize the $5,000 commission paid to its salesperson. The costs related to the delivery of the bid proposal should be immediately expensed because those costs would have been incurred even if the company did not ultimately obtain the contract. The contractor should amortize the recognized asset over the estimated life of the contract.

ASC 340-40-35-1 states that capitalized costs should be amortized "on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates." The pattern in which the related revenue is recognized could be significantly front-loaded, back-loaded, or seasonal, and costs should be amortized accordingly. If there is no evidence to suggest that a specific pattern of transfer can be expected, a straight-line amortization method may be appropriate.

Effective date

ASC 606 is effective for nonpublic entities for the annual reporting periods beginning after December 15, 2018. For most entities, this means a calendar year beginning January 1, 2019, and ending December 31, 2019. This will replace previous transaction and industry-based revenue recognition guidance with a principles-based approach.

The date of the initial application of the new standards is the start of the applicable reporting period (January 1 for a calendar-year entity). For most entities, this will be January 1, 2019. ■