DFW CFMA

What is Our Position and Strategy on Revenue Recognition and Lease Standards Changes?
Brief Firm Background

• Top 10 among CPA firm rankings
• Substantial Construction and Real Estate Practice
• Recent Addition of Gallina
My Background

• Started in 1989 as Construction Group was just building

• Currently Head of Construction Assurance within the industry group
  – Industries have primary role for quality and risk management
  – We also have a National Assurance Technical Group
  – Wrote firm’s comment letter on first Rev Rec exposure draft
My Background – cont.

- My current role: try to get consistent quality in construction assurance across the firm
  - Second review some critical/high risk engagements
  - Client acceptance/high level staffing assignments
  - Coordinate technical resources and help entire group work as a team
Overall Take on Revenue Recognition

• What do we **like** about current standards?
  – 81-1 tracks well with how jobs are bid, performed, billed, and wrapped up
  – Most practical implementation issues are addressed in the standard
  – Meaningful representation of revenue, cost of revenue, gross profit over time

◊ When bad accounting is the result, the problem is usually poor application of the current standards rather than bad standards
  • Story from early in my career: underbilled road job
Overall Take on Revenue Recognition – cont.

- Impact of estimates is enormous; current methods provide tools to manage the effect
  - Jobs in process schedules are relatively straightforward to understand
  - Effect of changes in estimates can be readily measured
    - Example: change order revenue over-recognized under the current standards in year one will become profit fade in year 2
Overall Take on Revenue Recognition – cont.

• What is NOT changing
  – Fundamental economics, with its importance of the individual contract as the key measure
  – Overall systems need to track billings and costs by job as a key management tool
  – One contract will normally be one performance obligation
  – POC will still be done
    ◊ Cost to cost still permitted
Overall Take on Revenue Recognition – cont.

• What Changes Will We Need to Deal With? (Just ideas, not a comprehensive list)
  – Variable consideration at inception
    ◊ Existing standards say we need to consider, but not much specific guidance
    ◊ New standard defines how to use likelihoods and probabilities to record
  – Unapproved Change Orders
    ◊ Become a form of variable consideration
    ◊ Now will use likelihoods and probabilities, rather than the hard rule
    ◊ Reality: unapproved change orders have been handled inconsistently in practice
Overall Take on Revenue Recognition – cont.

– Initial costs that benefit the entire performance of the contract may be handled differently
  ◊ Proposal costs, commissions: capitalize and amortize
  ◊ Bonds/Insurance/mobilization: capitalize and amortize

– Uninstalled materials
  ◊ Standard has confusing language
  ◊ New guidance in the works that should help
Overall Take on Lease Standard

• What do we **dislike** about the current standard
  - Inconsistent application of capital lease testing
    ◊ Example: SBA real estate loan example
  - Ability to plan around the standards to obtain desired results
    ◊ “Finance it off balance sheet!”
  - Some truly incomprehensible results
    ◊ Example capital lease asset cannot be removed even when the terms causing capital lease treatment are no longer there.
  - User confusion
    ◊ Properly capitalized real estate leases confuse bankers
    ◊ Lenders and sureties do not treat lease obligations as a real liability
Overall Take on Lease Standard – cont.

• What is changing
  – Leases longer than one year will all be booked by lessee
    ◊ Lease asset and lease liability booked at present value
    ◊ Asset amortized over the life of the lease; payments reduce the liability
    ◊ Exact nature of expense depends on the type of lease. I.e. there will still be some differences between “capital” and “operating” lease
Overall Take on Lease Standard – cont.

– Critical financial ratios will change
  ◦ If leasing activity is significant, the changes to ratios will be more problematic
  ◦ Obvious change is that measured leverage will increase
  ◦ Working capital will decrease because of current portion of liability
  ◦ Operating measures such as EBITDA could change because of changing character of expense