Revenue Recognition (ASC 606)

Where do you stand?

Greg Brown
September 27, 2018
Where are you in the process?

I’m on it!  

Meh! I’ll get there.
Agenda

• Overview of the new revenue recognition standard (ASC 606) as it stands today.
• Understand the critical issues to the construction industry as a result of changes in the new revenue recognition standard from previous GAAP.
• Review steps to begin taking for successful implementation of the new revenue recognition standard (ASC 606) and items to consider during implementation.
• Review examples of common issues companies may encounter in the application of ASC 606 within the construction industry.
ASC 606, Revenue from Contracts with Customers is here…
Let’s begin…

But

WHY??
Why was ASC 606 needed?

1. Inconsistencies in standards between IFRS and U.S. GAAP
   - **U.S. GAAP**
     - Broad revenue recognition concepts and detailed guidance for particular industries and transactions
     - Result – Different accounting for economically similar transactions
     - ASC 605 had different principles which were difficult to understand and apply
   - **US IFRS**
     - Limited guidance on topics such as revenue recognition for multiple-element arrangements
     - Entities would refer back to US GAAP
Why was ASC 606 needed?

2. Wasn’t one comprehensive revenue recognition model
   - Previous model was a “risk and rewards” based model
   - Didn’t align to the transfer of assets based on concept of “control”
   - Over 200 separate accounting pronouncements related to revenue recognition, but still lacking in a variety of areas (i.e. general guidance for service contracts)

The complexity and confusing nature of the current standard resulted in the #1 reason for restatements in financial reporting.
Why was ASC 606 needed?

3. Disclosures were inadequate
   • ASC 605 had **limited disclosure** requirements
   • Considered inadequate and lacked information to understand revenue arising from customers
   • **ASC 606 expands disclosure** to better understand the nature, amount, timing, and uncertainty of revenue that is recognized. Expanded disclosures include:
     • Disaggregated revenue data
     • Roll-forward of revenue data related to balance sheet accounts (contract assets and liabilities)
     • Qualitative discussion such as payment terms and nature of performance obligations
Why was ASC 606 needed?

4. Simplify and reduce the depth of guidance that entities must consider
   • One standard, one comprehensive framework

Sounds easy right!? 
When you thought everything would be easy peasy lemon squeezy but it’s actually difficult difficult lemon difficult
To help aid in revenue recognition implementation

Several resource groups and materials have been created:

• FASB created the “Joint Transition Resource Group” (TRG)
  • TRG issue papers should be considered as a source of guidance on how to apply the standard
• AICPA published the “New Revenue Recognition Accounting Standard – Learning and Implementation Plan”
  • Roadmap to ensure private companies and their management team and staff do the following:
    • Understand changes to current GAAP
    • Understand transition and retrospective adoption and how your company will adopt
    • Find resources to help train professional staff to ensure effective and efficient implementation
    • Educate users of changes to be expected
• AICPA Audit and Accounting Guide for Construction Contractors
Quick recap…so what is the major change in ASC 606
The five steps of revenue recognition

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract(s).
5. Recognize revenue when (or as) the entity satisfies a performance obligation.
So what does this mean?
BRACE YOURSELF

POLICIES AND PROCEDURES ARE COMING
Common Issues for Contractors
Step 1 : Identifying the Contracts With the Customer

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract(s).
5. Recognize revenue when (or as) the entity satisfies a performance obligation.
Common Issues in the Construction Industry
Step 1: Identifying the Contracts With the Customer

• When two contracts are entered into at or near the same time with the same customer, they must be accounted for as a single contract if any of the following criteria are met:
  1. The contracts are negotiated as a package with a single commercial objective,
  2. The amount of consideration payable under one contract depends on the price or performance under the other contract, or
  3. The goods are services promised in the contracts represent a single performance obligation.
It's QUESTION TIME!!
Example #1 – Identifying the Contracts with the Customer

• ABC Contractors enters into an engineering contract with Artificial Data for their new corporate headquarters. One month later, Artificial Data contracts with ABC Contractors for the construction of the building. Do the two contracts represent a single contract with the customer or two contracts?
Example #2 – Identifying the Contracts with the Customer

• ABC Contractors enters into an engineering contract with Artificial Data for their new corporate headquarters. Four months later, Artificial Data goes out to bid and contracts with ABC Contractors for the construction of the building. Do the two contracts represent a single contract with the customer or two contracts?
From the customer’s point of view…
What is the customer ultimately purchasing?
Impact of Customer Termination Rights and Penalties on Contract Terms

- Contracts that give the customer the right to cancel for convenience or other than for cause but do not give the contractor similar rights
- Termination clauses are included to provide the opportunity to suspend or terminate the project should unforeseen economic or political circumstances occur that significantly affect the return generated on the capital project
- Rarely terminated, because partial completion is of little value to customer, and the customer would incur additional cost akin to termination penalties

FASB ASC 606-10-32-4 states:
“For the purpose of determining the transaction price, an entity shall assume the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be canceled, renewed, or modified.”
Common Issues in the Construction Industry
Step 1 : Identifying the Contracts With the Customer

Impact of Customer Termination Rights and Penalties on Contract Terms

• The AICPA Financial Reporting Executive Committee (FINRec) believes that because a contractor has an ongoing enforceable obligation, often backed by surety bond or letter of credit, to deliver the full scope of work specified in a contract with a customer, until the scope of work is completed or the customer terminates the contract, the contractor should reflect this obligation in the accounting and disclosure of remaining unsatisfied performance obligations until such time that the contract is terminated.
Impact of Customer Termination Rights and Penalties on Contract Terms – Example #1

ABC Contractor enters into a design and construction contract for a high-tech manufacturing facility. Would the contract term be based on the defined scope in the contract or the passage of time?
Impact of Customer Termination Rights and Penalties on Contract Terms – Example #2

ABC Contractor enters into a recurring maintenance services contract with a customer. The contract is for an indefinite term and includes a termination provision that allows either party to cancel for convenience upon 30 days notice. The contract states the customer will compensate the contractor in accordance with the terms of the contract for services provided through the termination date. How should this contract be accounted for?
Impact of Customer Termination Rights and Penalties on Contract Terms – Example #3

ABC Contractor enters into a contract to perform small capital projects at a customer’s facility for a period of three years, with a renewal option for another three years. The renewal option does not represent a material right. There is no termination for convenience clause in the contract. What is the term of the contract in this example?
NAILED IT
Common Issues for Contractors within the Five Step Model

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
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4. Allocate the transaction price to the performance obligations in the contract(s).
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Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

Background

• FASB ASC 606-10-25-14 – Establishes 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
  a) a good or service (or bundle of goods or services) that is distinct or
  b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

Background

• FASB ASC 606-10-25-15 – Explains that a series of distinct goods or services has the same pattern of transfer to the customer if both of the following are met:
  a) Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in FASB ASC 606-10-25-27 to be a performance obligation satisfied over time.
  b) In accordance with paragraph 31-32 of FASB ASC 606-10-25, the same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation to transfer each good or service in the series to the customer.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

Application of the series guidance is not an alternative and must be used when applicable. Two examples of contracts that may be subject to the series guidance are:

a) A contractor has a contract with a university to construct four dormitories. Each of the four dormitories are highly standardized and meet the criteria for being substantially the same.

b) A contractor has a contract with Taco Town to install security and surveillance equipment at 10 different locations. Each package of security and surveillance equipment to be installed at each location is very similar due to the standardization in store layout. Labor requirements are expected to be consistent at each location. As a result, the criteria for being substantially the same have been met.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

Determining whether a good or service is distinct is a matter of judgement.

• **FASB ASC 606-10-25-19(a)**
  - Looks to the economic substance of each good or service to determine whether a customer can benefit from that good or service on its own or with readily available resources.

• **FASB 606-10-25-19(b)**
  - Requires the contractor to evaluate whether the promised good or service in the contract is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract)

• **FASB 606-10-25-21**
  - Provides a nonexclusive list of indicators for a contractor to consider.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

When evaluating whether the individual goods and services are separately identifiable,

“entities should evaluate whether the contract is to deliver (a) multiple goods or services or (b) a combined item or items that is comprised of the individual goods and services promised in the contract.”

Said another way:

Entities should evaluate whether the individual goods and services are outputs or, instead, inputs of a combined project.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

The principle of “separately identifiable” is based on the notion of separable risk.

• Whether the risk that an entity assume to fulfill its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services.

• FASB ASC 606-10-25-21(a) suggests a promised good or service in a contract is not distinct from the other promised goods or services where the contract is for the construction of a single, combined output resulting rom the contractor’s significant service of integrating the component goods and services of the contract.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

FinREC – An important factor for determining that goods or services should be combined with an integration of service into a single performance obligation is that the risk the entity assumes in performing the integration service is inseparable from the risk relating to the transfer of the other promised goods or services.

Judgement about the risk an entity assumes with respect to a promised good or service can often be inferred by certain terms of the contract, such as the contractor’s acceptance or warranty provisions.
Common Issues in the Construction Industry
Step 2 : Identifying the Performance Obligations in the Contract

FinREC believes in some circumstances, the engineering may not be significantly integrated with the construction (such as when engineering and construction are performed in separate and distinct phases for which the customer has the option of awarding construction to a different contractor upon completion of the engineering).

Significant judgment is required in making this assessment, and the conclusion should be based on specific facts and circumstances. Careful consideration should be given to the degree of the integration service provided in the context of the contract.
USE YOUR

"BEST JUDGMENT"
It's QUESTION TIME!!
Step 2 : Identifying the Performance Obligations in the Contract

Example #1

ABC Construction (the contractor) enters into a contract with the State Transit Authority (the customer) to design and construct a commuter rail line and maintain the line along with other lines that are already operational. The maintenance services consist of regular scheduled maintenance of the rail lines; major overhaul services are not within the scope of this contract. The design and construction work is expected to take five years to complete. The maintenance and other lines that are already operational will be transitions from being performed in-house by State Transit Authority to ABC Construction within one year, and the maintenance portion of the contract will continue for 20 years.

Step 2: Identify the performance obligations in this contract.

When performing this step ABC Construction came up with the following…
Step 2 : Identifying the Performance Obligations in the Contract
Example #1

When brainstorming the ABC Construction management team determined:

1) Each of the promises in the contract (design, construction, and maintenance services) is capable of being **distinct**

2) The **customer can benefit from the goods and services either on their own or together with readily available resources**. Evidenced by the fact that other entities regularly sell these services separately to other customers.

So what was their final conclusion? Are there one, two or three separate performance obligations within this contract?
Drum roll please
Step 2 : Identifying the Performance Obligations in the Contract
Example #1
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Common Issues in the Construction Industry
Step 2: Identifying the Performance Obligations in the Contract

It will be important that **policies and procedures** are in place to identify performance obligations in contracts when setting up jobs in the accounting system.

- When they should be combined into one performance obligation and

- When they should be considered a separate performance obligation

Define what meets the criteria of being distinct, implement processes for evaluating contract modifications, and establish procedures for identifying a series.
ACED IT!
Common Issues for Contractors within the Five Step Model

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Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Background
• Factors to consider in estimating the transaction price:
  • Transaction price of a contract is affected by a variety of uncertainties that depend on the outcome of a series of future events.
  • Must be revised throughout the life of the contract when events occur and uncertainties are resolved.
  • Consideration must be given to:
    a) The basic contract price;
    b) Contract options;
    c) Change orders;
    d) Claims; and
    e) Contract provisions for penalty and incentive payments, including award fees and performance incentive.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Common Forms of Variable Consideration Found Within Contracts
• Change orders *(including unpriced change orders)*
• Claims
• Back charges
• Extras, and
• Contract provisions for penalty and incentive payments, including award fees and performance incentives.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Change Orders

• Accounting for change orders depends on the underlying circumstances, which may differ for each change order, depending on the customer, the contract, and the nature of the change.

• Under ASC 606, if the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with estimating variable consideration and constraining estimates of variable consideration.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Factors to consider when estimating the change in the transaction price as it relates to unapproved, unsigned change orders

a) The customer’s written approval of the scope of the change order;
b) Current contract language that indicates clear and enforceable entitlement relating to the change order;
c) Separate documentation for the change order costs that are identifiable or reasonable; or
d) The entity’s favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Contract modifications should be accounted for as a separate contract (or performance obligation) if both of the following conditions are present:

1. The scope of the contract increases because of the addition of promised goods or services that are distinct (KEY: the good or service has utility AND is separately identifiable); and

2. The price of the contract increases by an amount that reflects the contractor’s estimated cost of the additional promised good or services, adjusted to reflect the circumstances of the particular contract.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Incentives and Penalties

• Should **not automatically** be **included** in the transaction price
• **May require substantial judgment and experience** with types of activities covered by the contract
• Estimates of performance relative to targeted performance are similar to processes used to estimate completion on long-term contracts.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

In accordance with ASC 606, entities are required to make estimates of variable consideration in determining the contract price, subject to the guidance of constraining estimates of variable consideration.

In formulating the estimate, entities should consider:
• Historical,
• Current, and
• Forecasted information

The information considered in estimating variable consideration typically would be similar to the information the entity used during the bid-and-proposal process and in establishing prices for a promised good(s) or service.
Common Issues in the Construction Industry

Step 3: Determine the Transaction Price

Two methods for estimating variable consideration:

a) The expected value method.
   Sum of probability-weighted amounts in a range of possible consideration amounts. (generally used when more than two possible outcomes)

b) The most likely amount.
   Single most likely amount in a range of possible consideration amounts. (generally used when two possible outcomes)

The number of possible outcomes should not cause an entity to automatically choose one method, but rather the method selected should be dependent on which method the entity expects to better predict the amount of consideration entitled.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

ASC 606-10-32-9

- Requires **one method be applied consistently** throughout the contract when estimating variable consideration
- **Method should be applied consistently** to contracts with similar characteristics and in similar circumstances
- **Method should be applied to types of variable consideration** with similar characteristics and similar circumstances.
Step 3 : Determine the Transaction Price

Example #1

A contract is negotiated with a fixed price plus an award fee that is tied to delivery by a specified date. The entity subcontracted a portion of the work and estimates that it will achieve the award fee due to the contract not being considered complex. The company has a history of the subcontractor delivering on similar timelines, and both the entity and subcontractor currently estimate completion up to six months prior to the specified date.

What would you consider to be the best method to use in this scenario?

Expected method or most likely amount
Step 3 : Determine the Transaction Price

Example #2

An entity contracts to build a solar energy plant for a customer and received an incentive fee from the customer that varies depending on objectivity determinable key performance indicators associated with energy savings over a one year period. The entity has extensive experience determining energy savings under various conditions that impact solar energy.

What would you consider to be the best method to use in this scenario?

Expected method or most likely amount
Step 3 : Determine the Transaction Price
Example  #3

An entity contracts to build a road on January 1 with an agreed-upon completion date of June 30. The contract calls for liquidated damages in the event that contractor-caused delays result in the road not being completed by June 30.

What would you consider to be the best method to use in this scenario?

Expected method or most likely amount
SO EASY

A CAVEMAN CAN DO IT
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Constraining Estimates of Variable Consideration

• ASC 606-10-32-11 - Discusses when to include variable consideration in the transaction price and notes that an entity shall include in the transaction price some or all of the variable consideration amount estimated in accordance with FASB 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.

• The entity should consider the likelihood and magnitude of a revenue reversal

• ASC 606 defines probable as 75-80% likelihood of occurring
Common Issues in the Construction Industry

Step 3 : Determine the Transaction Price

Constraining Estimates of Variable Consideration

• FinREC believes that certain types of variable consideration (such as consideration associated with claims or unapproved change orders) may be recorded when settled only after consideration of both the likelihood and magnitude of a reversal.

• First assess the contract modification guidance for enforceability

• Entities are required to estimate the amount of variable consideration applying the constraint guidance and should not default to the conclusion no amount of variable consideration should be included in the transaction price.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Constraining Estimates of Variable Consideration

1) The amount of consideration is highly susceptible to factors outside the entity’s influence. Those factors include the volatility in the market, the judgement or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

2) The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

3) The entity’s experience (or other evidence with similar types of contracts) is limited, or that experience (or other evidence) has limited predictive value.

4) The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

5) The contract has a large number and broad range of possible consideration amounts.
Common Issues in the Construction Industry
Step 3 : Determine the Transaction Price

Policies should be developed to account for variable consideration and estimation methods that will be used which will result in consistent outcomes under similar economic circumstances. For example:

• Additional contract value should be recognized for unapproved/unpriced change orders and claims only upon achievement of standard criteria for contracts.

• Recognition of performance incentives should be based upon achievement of key milestones or metrics that historically indicate achievement of the incentive is probable.

• Estimates for liquidated damages or other penalties should be provided for in the contract value until key milestones or metrics that historically indicate realization of such amounts is not probable.
Step 3 : Determine the Transaction Price
Example #4 – Performance Incentive (most likely amount method)

Contract characteristics:
• A contract with a customer for fixed consideration of $10,000,000, plus a performance incentive of $336,000 for timely completion. Aggregate potential contract value: $10.336 million.
• The contract is for a single performance obligation that is satisfied over time.
• The contract requires substantial completion 96 weeks after receipt of the notice to proceed.
• Performance incentives are achieved on 60% of contracts with similar characteristics.

Determine the transaction price at contract inception?
Step 3 : Determine the Transaction Price
Example #4 – Performance Incentive (most likely amount method)

Now let’s move forward on the project to week 75 of contract performance where the contract is 80% complete and on track for timely completion. What should the transaction price point in time?
Step 3 : Determine the Transaction Price
Example  #5 – Liquidated Damagers (expected value method)

Contract characteristics:

- A contractor enters into a contract with a customer to construct a commercial building for fixed consideration of $12 million.
- The construction of the building is a single performance obligation that is satisfied over time.
- The contract requires achievement of substantial completion 120 weeks after inception of the notice to proceed and assesses $20,000/day in liquidated damages for each day substantial completion exceeds the target.
- Based on past experience, the contractor occurs liquidated damages on contracts according to the probabilities in the following table.

<table>
<thead>
<tr>
<th>Possible period of delay</th>
<th>$LDs/day</th>
<th>Total $ LDs</th>
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Step 3 : Determine the Transaction Price
Example #5 – Liquidated Damagers (expected value method)

• A contractor enters into a contract with a customer to construct a commercial building for fixed consideration of $12 million.

• The construction of the building is a single performance obligation that is satisfied over time.

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At contract inception, what would be the value of the contract?
### Step 3: Determine the Transaction Price
#### Example #5 – Liquidated Damagers (expected value method)

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Policies and Procedures to Consider Related to Variable Consideration

Assessing constraint on variable consideration (probability of reversal) will involve **significant judgments and estimates** and is an area of significant risk of inconsistent results.

Accumulating **historical results** and utilizing averages will likely be one set of inputs used to make these judgements and estimates, but other inputs will need to be incorporated. For example:

1. Establishing methods for determining the probabilities of various estimates of variable consideration;
2. Determining which estimation methods best predict the entitled amount of consideration; and
3. Management’s level of conservatism with respect to reporting results, as well as others.
Common Issues for Contractors within the Five Step Model

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract(s).
5. Recognize revenue when (or as) the entity satisfies a performance obligation.
What additional guidance did the FASB, FinREC, and TRG say needed to be added related to implementation issues related to Step 4 – Allocate the transaction price to the performance obligations in the contract(s) specific to engineering and construction contractors?
Currently there is a placeholder for additional guidance, but as for now, current guidance within ASC 606 is considered sufficient and no implementation issues were considered necessary to add to the section related to implementation for engineering and construction companies.
Common Issues for Contractors within the Five Step Model

1. Identify the contract(s) with the customer.
2. Identify the separate performance obligations in the contract(s).
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract(s).
5. Recognize revenue when (or as) the entity satisfies a performance obligation.
Common Issues in the Construction Industry

Step 5 : Recognize revenue when (or as) the entity satisfies a performance obligation

Differences between ASC 606 vs. current GAAP ASC 605
1. Losses will be measured at either the performance obligation or contract level
2. Wasted materials and inefficient labor should be excluded when measuring progress
3. Uninstalled materials
4. Precontract costs
Common Issues in the Construction Industry

Step 5 : Recognize revenue when (or as) the entity satisfies a performance obligation

ASC 340-40 provides accounting guidance for certain costs related to contracts with customers. Specific costs addressed include

1. Incremental costs of obtaining a contract with a customer; and
2. Costs incurred in fulfilling a contract with a customer

Contractors will recognize as an asset certain costs related to a contract that have not been recognized as assets previously, assuming the costs are expected to be recovered.

Cost will be amortized to the contract as work is performed and assessed for impairment.

Practical expedient! – permits expensing of certain costs as incurred if the amortization period is one year or less. Will need to be disclosed if using practical expedient.
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Incremental Costs of Obtaining a Contract

- Includes cost that you would not incur if you do not obtain the contract.
- Sales commissions,
- Costs incurred during the proposal, and
- Negotiation.

- If recovery is expected, costs should be recognized as an asset and amortized over the performance of the contract.

- Remember, there is a practical expedient allowed (amortization period is one year or less)
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Precontract costs
• May consist of:
  • Engineering, design, mobilization, or other services performed on the basis of commitments or other such indications of interest;
  • Costs for production equipment and materials relating to specific anticipated contracts (for example, costs for the purchase of equipment, materials, or supplies);
  • Costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of follow-on orders for the same item; and
  • Startup or mobilization costs incurred for anticipated but unidentified contracts.

Should first be evaluated for capitalization under current standards: inventory (ASC 330), property, plant and equipment (ASC 360), of software (ASC 985).
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Precontract costs incurred for a specific anticipated contract that are not addressed under other authoritative literature would be recognized as an asset only if they meet all of the criteria in paragraphs 5 – 7 of FASB ASC 340-40-25 (e.g., direct labor, direct materials, costs explicitly chargeable to the customer under the contract) cost to fulfill a contract.
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Cost Incurred in Fulfilling a Contract should meet the following criteria:

1. The costs are directly related to a contract;
2. The costs generate or enhance resources of the contractor that will be used in satisfying performance obligations; and
3. The costs are expected to be recovered.
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Examples of Cost Incurred That Relate Directly to a Contract (or anticipated contract):

1. Direct labor (salaries and wages of employees who provide the promised services directly to the customer)
2. Direct materials (supplies used in providing the promised services to a customer)
3. Allocations of costs that relate directly to the contract or to contract activities (costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract)
4. Costs that are explicitly chargeable to the customer under the contract
5. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).
Common Issues in the Construction Industry
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Uninstalled materials
FASB ASC 606-10-55-21(b) provides four criteria that, if all are met, may indicate a cost incurred is not proportionate to the entity’s progress in satisfying the performance obligation and, therefore, the best depiction of the entity’s performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred.

These criteria are as follows:
• The good is not distinct.
• The customer is expected to obtain control of the good significantly before receiving services related to the good.
• The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
• The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal in accordance with paragraphs 36–40 of FASB ASC 606-10-55).
Common Issues in the Construction Industry

Step 5 : Recognize revenue when (or as) the entity satisfies a performance obligation

Warranties

- **Warranty Sold Separately**
  - Warranty will qualify as a separate distinct performance obligation

- **No Option to Purchase a Warranty**
  - Are any express or implied warranties in the contract conveying a service in addition to the project complying with the agreed upon specifications.
  - If it is concluded a service is being provided, the warranty would be accounted for as a separate performance obligation and allocated a portion of the transaction price.
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

Examples of when a warranty providing a service may exist:

1. Contractor installs landscaping, irrigation, and water amenities and is required to maintain and/or replace any defective components of the landscaping for a period of five years after project completion when the typical warranty period is two years.

2. Contractor installs solar panels and warrants that all solar panels installed will collectively generate 60 MW of power for a 24 month period after installation.

3. An industrial grade water pump is installed by a contractor as part of the expansion of a water treatment plant. The pump carries a warranty by the contractor to perform as intended for a ten-year period.
Common Issues in the Construction Industry

Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation

In assessing whether a warranty provides a service, the contractor should consider factors such as:

1. Whether the warranty is required by law (normally indicates a promised warranty is not a separate performance obligation since such warranties protect the customers from defects)

2. The length of the warranty coverage period (the longer the warranty period, the more likely a service will be provided in addition to the assurance the product complies with agreed-upon specifications); or

3. The nature of the tasks the contractor promises to perform to provide assurance the project complies with agreed-upon specification normally indicates those tasks do not give rise to a separate performance obligation

Judgement should be applied to the services required and the materiality and length of the warranty must be considered.
Walkthrough of Five Steps Example
Disclosure Requirements
Disclosure Requirements

Qualitative and qualitative information will be required to be disclosed related to:

• The contracts with customers
• The significant judgments, and changes in the judgments, made in applying the standard to those contracts; and
• Any assets recognized from the costs to obtain or fulfill a contract with a customer.
Disclosure Requirements

Disclosure of contracts with customers

- An entity shall disclose all of the following amounts for the reporting period
- Revenue recognized from contracts with customers, which the entity shall disclose separately from other sources of revenue
- Any impairment losses recognized on any receivables or contract assets arising from an entity’s contracts with customers, which an entity shall disclose separately from impairment on losses from other contracts.
Disclosure Requirements

Disaggregation of Revenue

• Private entities may elect not to apply the quantitative disaggregation disclosure guidance.
• If not disclosing, at a minimum, the entity shall disclose:
• Disaggregated revenue according to the timing of transfer of goods or services (i.e. revenue from goods or services transferred to customers at a point in time vs. over time) and qualitative information about how economic factors (e.g. type of customer, geographic location of customers, type of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows.
Disclosure Requirements

Performance obligations
An entity should disclose information about its performance obligations in contracts with customers, including a description of all of the following:

1. When the entity typically satisfies its performance obligation (e.g. upon shipment, upon delivery, as services are rendered, upon completion of a service) including when performance obligations are satisfied in a bill-and-hold arrangement;

2. Significant payment terms;

3. The nature of the goods and services that the entity has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (i.e. if the entity is acting as an agent);

4. Obligations for returns, refunds, and other similar obligations; and
Overview of basic implementation process
Implementation Framework

1. Understand the New Standard
2. Gather Information
3. Evaluate Impact
4. Select Transition Approach
5. Design Solution
6. Implement and Monitor
Gather Information

- Gather relevant information to understand impact of standard:
  - Identify types of customer agreements
  - Gather examples of customer agreements for each type
  - Pricing information:
    - Transaction price if available for separate and distinct performance obligations
    - Pricing structure
    - Any instances of variable consideration
  - Data needed for estimates:
    - Historical change order/claims results, if available
    - Historical experience with incentive/penalty provisions
    - Warranties
  - Current policies, process and control documentation
  - Compensation plans
  - IT system configurations
Evaluate Impact

• Establish cross-functional team:
  • Accounting, tax, compensation and benefits (if determined to be impacted), IT, legal, sales
  • Evaluate impact of new standard and review customer agreements and identify differences

• Some areas to consider:
  • Customer contracts with unique revenue recognition considerations or terms and conditions;
  • The degree of variation in the contracts with customers;
  • Different business lines or multiple geographies that could involve different implicit promises through differences in customary business practices;
  • The degree to which contracts include multiple performance obligations and/or variable consideration;
  • Document conclusions on how to apply the new standard
Evaluate Impact (cont.)

• Systems impact
  • If new performance obligations are identified, assess ability of current systems to capture separate performance obligations and recognize revenue when performance is satisfied
  • Assess system ability to capture data for disclosure requirements

• Data used in estimates
  • Identify any new data required to determine transaction price and make other estimates related to variable consideration

• Tax impact
  • Need to involve tax professionals
  • May impact timing of when revenue is recognized, leading to temporary differences and also impact sales and use taxes
Evaluate Impact (cont.)

• Compensation
  • Timing of revenue may impact sales commissions, bonuses, and other employee incentive plans
  • May need to revise incentive plans
• Business practices and strategies (e.g., pricing, marketing, and contracting)
  • May need to be revised
Implement Transition Approach

The standard provides two methods to apply the changes resulting from the application of the new rules. Significant planning should go into the method to be used in order to achieve organization goals.

• **Retrospective**
  • When using this application option, the organization can elect practical expedients in the area of completed contracts within a reporting period, use of contract price at date of completion rather than use of an estimate, and for all periods before initial application an entity is not required to disclose amounts of transaction price allocated to remaining performance obligations.

• **Cumulative effect**
  • Comparative periods presented would not have to be restated. Under this option, the new rules would be applied only to contracts that are uncompleted at the date of initial application.
Design Solution

- Design solution is based on the impact evaluation:
  - Transition approach determined
  - Nature and extent of changes in revenue recognition identified:
    - Performance obligations identified
    - Transaction Price identified
    - New information required identified
  - Nature and extent of changes needed in other areas identified:
    - Develop project plan and timeline
    - Consider need for project manager and steering committee
    - Identify resources needed
  - Communicate plan and gain consensus
  - Ensure alignment with independent and internal audit
Implement and Monitor

• Implementation varies based on degree of change and impact to the organization

• Depending on complexity, may need steering committee and PMO

• Keep all stakeholders informed

• Establish monitoring process
  • Validate that changes have been implemented and are operating
  • Key controls are in place and operating effectively
Thank You

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