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Revenue Recognition: General Construction, Heavy Highway, and Architecture/Engineering

January 24, 2018

Andrea Castle

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Today's Speaker

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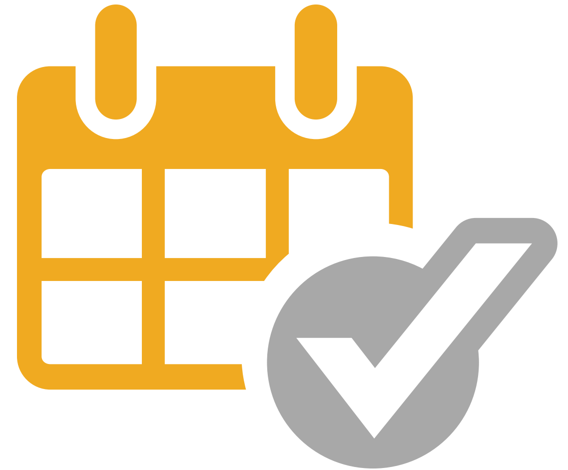
Agenda

- Contractor and architecture/engineering firm considerations
- Transition
- Implementation framework



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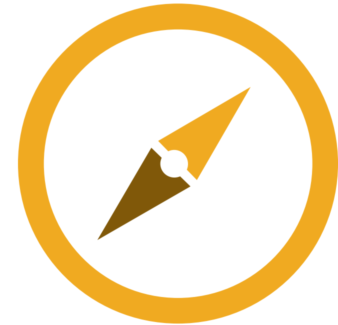
Objectives

As a result of participating in this session, you should be able to:



- Identify different performance obligations in a contract
- Identify when to record variable consideration in the contract price
- List what changes or additions should be made to the Company’s internal controls
- Obtain a potential example implementation approach to assist with their adoption of the standard

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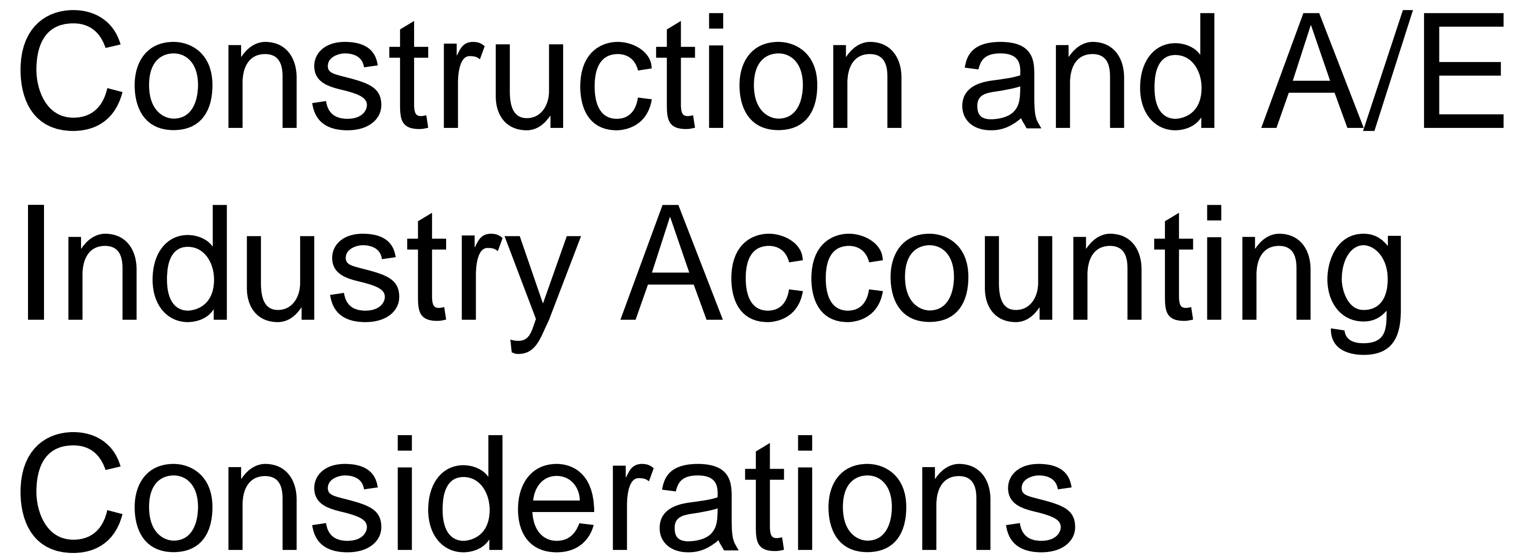
Construction and A/E
Industry Accounting
Considerations

Step 1: Identify the Contract(s) with the Customer

- To apply the model, an entity must first identify the contract, or contracts, to provide goods and services to customers.
- Any contracts that create enforceable rights and obligations fall within the scope of the new guidance.
- Such contracts may be written, oral or implied by the entity's customary business practice.
- Potential use of a portfolio approach to analyzing contracts

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Step 1: Identify the Contract(s) with the Customer

The new revenue model will be applied to a contract only when all of the following conditions are met:

- Each party has approved the contract and is committed to perform their respective obligations
- Each party's rights regarding the goods or services to be transferred can be identified
- The payment terms for the goods or services to be transferred can be identified
- The contract has commercial substance
- Collection is probable
- A contract does not exist if each party can terminate the contract prior to any performance occurring without having to compensate the other party

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Step 1: Combining Contracts and Modifications

- Contracts entered into at or near the same time with the same customer should be combined if any of the following conditions are met:
  - They were negotiated as a package with a single commercial objective
  - Consideration to be paid in one contract depends on the price or performance of the other contract
  - Some or all of the goods or services promised in the contracts are a single performance obligation

- A contract modification is any change in the scope and/or price of the contract
  - Results in a new contract if:
    - Scope change is a result of adding distinct goods/services
    - Increase in the contract price is equal to the stand-alone selling price
  - All other modifications are considered to be part of the original contract

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Internal Control Considerations for Step 1

- Identify contracts (whether written or unwritten) that meet the criteria defined in FASB ASC 606-10-25-1
- Reassess arrangements not initially meeting the criteria of a contract in accordance with FASB ASC 606 due to the possibility of significant changes occurring in the underlying facts and circumstance
- Assess management's and the customer's commitment and ability to perform under the contract
- Ensure payment terms are properly considered
- Assess the collectibility criterion
- Evaluate whether combined or individual contracts meet the various criteria specified in FASB ASC 606-10-25-9
- Evaluate contract modifications

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Step 2: Identify the Performance Obligations in the Contract

- An entity must identify the promised goods and services within the contract and determine which of those goods and services are separate, or distinct, performance obligations (i.e., the unit of accounting for purposes of applying the standard).
- An entity must also determine if a series of distinct goods or services are substantially the same and whether they have the same pattern of transfer to the customer.

Separate, or distinct, performance obligations

- Two step process to determine whether a promised good and service (or bundle of goods and services) is distinct:
  - (1) consider the level of the individual good or service (i.e., the goods or services are capable of being distinct), and;
  - (2) consider whether the good or service is separable from other promises in the contract (i.e., the good or service is distinct within the context of the contract)

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Step 2: Engineering and Construction (E&C) Contracts

- Judgmental area where the customer is often receiving multiple goods and services
  - E&C contracts must consider whether the engineering component is significantly integrated with the construction component or whether these components are stand alone performance obligations.
  - Example E&C project types include:
    - Design Build
    - Design Build Operate Maintain
    - Engineer, Procure, Construct (EPC)
    - Design and Construction Management
  - Operation and maintenance work will typically be a separate performance obligation

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Step 2: Other Judgement Areas

- Self-perform work should be evaluated to determine if it is separable from the integration services being provided
- Contracts that include work performed at multiple locations that is not integrated
- Pre-construction
- Warranty work
  - Option to purchase separately – separate performance obligation
  - Warranty for latent defects is automatically provided and cannot be separately purchased – not a separate performance obligation
    - Accrue for the anticipated warranty costs
- Engineering contracts with a listing of tasks

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Polling Question #1

Which of the following types of potential distinct separate performance obligations does your company have?

A. Warranties that are sold separately
B. Contracts that include work performed at separate sites
C. E&C projects
D. Engineering contracts with multiple tasks
E. None of the above
F. More than one

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Internal Control Considerations for Step Two

- Identifying performance obligations, including those explicitly stated in the contract and those that may be implied based on customary business practices

- Evaluating whether a promised good or service is distinct, particularly within particular contracts

- Evaluating whether a series of goods or services should be treated as a single performance obligation

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Step 3: Determine the Transaction Price

- The transaction price is based on the amount to which the entity expects to be “entitled”

- This amount is meant to reflect the amount that the entity has rights to under the present contract

- The transaction price does not include:
  - Estimates of consideration from future change orders for additional goods and services
  - Amounts collected on behalf of another party, such as sales taxes

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Step 3: Termination for Convenience Clauses

- Termination for convenience clauses that can be cancelled by the customer but not the Company
- For purposes of determining the transaction price, an entity should 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 cancelled, reviewed, or modified

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Step 3: Variable Consideration Forms and Constraint

- Common construction industry variable forms of consideration include:
  - Unpriced change orders
  - Claims
  - Incentive payments
  - Penalty provisions/liquidated damages

- Variable consideration constraint – include variable consideration in the transaction price only to the extent 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
  - Significant is relative to the cumulative revenue recognized to date on the contract

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Step 3: Revenue Reversal Factors to Consider

- Consideration is highly susceptible to factors outside the entity's influence
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time
- The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value
- 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
- The contract has a large number and broad range of possible consideration amounts

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Step 3: Estimating Variable Consideration

- Two methods for estimating variable consideration
  - Expected value
    - Determined by the sum of probability-weighted amounts in a range of possible consideration amounts
    - Most predictive when there are many possible results

  - Most likely amount
    - Based on the single most likely amount in a range of possible consideration amounts
    - More appropriate when two outcomes are being considered

- One method should be applied consistently for each type of uncertainty in contract and to contracts with similar characteristics and similar circumstances. Different methods can be used for different types of uncertainties within a contract.

- The method selected should be the best depiction of the amount to be received versus the Company having the option to pick either method

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Polling Question #2

What type of variable consideration does your entity generally have?

A. Performance based bonuses
B. Liquidated damages provisions
C. Change orders
D. Claims
E. More than one
F. All of the above

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Step 3: Impact at Adoption

- Potential impact
  - Contractors/firms who currently estimate unpriced change orders/claims
    - Likely little impact
  - Contractors/firms who only record change orders once signed and claims once settled
    - May see acceleration in revenue recognition
    - May have a significant amount of revenue/profit never recorded to the income statement upon adoption

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Step 3: Customer Furnished Equipment/ Materials

- Principal versus agent considerations determines whether revenue is recorded gross or net
- Principal
  - Provides goods/services by controlling them before transferring to the customer
- Agent
  - Arranges for another party to provide the good/service

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Step 3: Other Transaction Price Considerations

- Financing component – extended payment terms are granted to the customer to provide financing
  - Only needs to be considered if payment will come more than a year after providing good/service
- Traditional retainage is not considered financing as it is withheld to ensure performance by the contractor, not as a financing mechanism
- Non-cash consideration is measured at fair value

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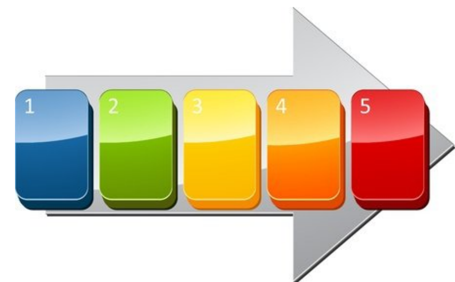
Internal Control Considerations for Step 3

- Estimating the amount to which the entity expects to be entitled – that is, the transaction price – including any variable consideration
- Evaluating whether any portion of variable consideration should be constrained
- Identifying and measuring whether there is a significant financing component in the contract



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Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

- Once the separate performance obligations are identified and the transaction price has been determined, the standard requires an entity to allocate the transaction price to the performance obligations.

- Generally, this is done in proportion to their standalone selling prices (i.e., on a relative standalone selling price basis)

- Any discount within the contract generally is allocated proportionally to all of the separate performance obligations in the contract.

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Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

- The allocation is made at the inception of the contract and is not subsequently adjusted for changes in the stand-alone selling prices

- Changes to the contract price that change subsequent to the inception of the contract (for example, due to the resolution of uncertain events or circumstances) should be allocated to the performance obligations in the contract on the same basis that was used at the contract's inception

- Amounts allocated to a satisfied performance obligation should be recognized in revenue in the period in which the transaction price changes

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Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

- Estimates of stand-alone selling prices should maximize the use of observable inputs
- When a purely observable stand-alone price is not available, methods of estimating the stand-alone price include (but are not limited to):
  - **Adjusted market assessment** – the entity would estimate what customers would be willing to pay or consider competitors' prices for similar goods and services, as adjusted to reflect the entity's costs and margins
  - **Expected cost plus a margin** – the entity would forecast its expected costs of satisfying a performance obligation and add an appropriate margin
  - **Residual approach** – can only be used if A) the entity sells the same good or service to different customers for highly variable selling prices or B) the entity has not yet established a price for the good or service

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Internal Control Considerations for Step 4

- Estimating the stand-alone selling price, including the maximizing of observable inputs in that process
- Determining the appropriate transaction price allocation, including variable consideration and discounts
- Refreshing estimates or assumptions

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Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

- An entity recognizes revenue only when it satisfies an identified performance obligation by transferring a promised good or service to a customer

- A good or service is considered to be transferred when the customer obtains control.
  - Recognizing revenue upon a transfer of control is a different approach from the "risks and rewards" model that currently exists in today's guidance

- Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset

- Control also means the ability to prevent other entities from directing the use of, and receiving the benefit from, a good or service

- An entity must determine at contract inception whether it will transfer control of a promised good or service over time
  - If an entity does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time.

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Step 5: Method of Recognizing Revenue

- Companies should consider whether an input or output method best depicts the transfer of control to the customer
- If an output method does not take into account WIP, this may not be an appropriate measure of progress
- The same method should be utilized for similar goods/services
- Input methods
  - The Company should exclude significant inefficiencies from the measure of progress that were not reflected in the price of the contract

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Step 5: Uninstalled Significant Materials

- Revenue related to the installation of significant uninstalled permanent materials will be recognized to the extent of their cost upon transfer of control to the customer

- Materials acquired for which the cost does not depict overall performance

- Current practice – recognize revenue and cost once received at job-site

- New guidance
  - Exclusion from the measurement of progress
  - Inclusion only to the extent of cost

- Significant in relation to the overall performance obligation

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Step 5: Right to Invoice Practical Expedient

- If an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity may recognize revenue in the amount to which the entity has a right to invoice
  - A maintenance service contract in which an entity bills a fixed amount for each hour of service provided may allow for use of the practical expedient
- Maintenance service contracts with variable consideration
- Lump sum contracts
- Contracts with significant up front payments would make it challenging to evidence use of this method as an appropriate depiction of transfer of goods/services to a customer
- Inclusion of a schedule of values that outlines billing timing and amounts within the contract does not provide evidence that the amount invoiced is representative of the performance completed to date

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Internal Control Considerations for Step 5

- Determining whether performance obligations are satisfied at a point in time or over time

- Measuring progress toward complete satisfaction of a performance obligation that is satisfied over time (that is, the input and output methods)

- Recognizing revenue only when (or as) control is transferred to the customer

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Polling Question #3

Which step from the new model do you believe will be the most complicated to address or implement?

A. Step One – Identify the contract(s) with the customer
B. Step Two – Identify performance obligations
C. Step Three – Determine the transaction price
D. Step Four – Allocate the transaction price to the performance obligations
E. Step Five – Recognize revenue when (or as) performance obligations are satisfied

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Loss Contracts

- The provision for losses will be determined at the contract level
- If Companies make an accounting policy election, they can determine the provision for losses at the performance obligation level
  - If the election is made, it would need to be applied in the same manner to similar contracts

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Incremental Costs of Obtaining a Contract

- Costs of obtaining a contract should be recognized as an asset if the costs are incremental and are expected to be recovered
- Definition – Those costs that the entity would not have incurred if the contract had not been obtained
- Practical expedient – these costs can be recognized as expense when incurred if the amortization period of the asset that the entity would have recognized is one year or less

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Precontract Costs

- Precontract costs result in no future benefit unless the contract is obtained
- Example precontract costs
  - Engineering, design, mobilization and other services performed based on commitments or other indications of interest
  - Costs for production equipment and materials relating to specific anticipated contracts
  - Costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of follow-on orders for the same item
  - Startup or mobilization costs incurred for anticipated but unidentified contracts
- Should be analyzed for capitalization under other authoritative literature first
- If they do not fall under other guidance, amounts can be capitalized if:
  - They relate to a specifically identifiable contract
  - The costs generate or enhance resources of the entity that will be used in satisfying a performance obligation in the future
  - The costs are expected to be recovered

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Disclosure Requirements and Financial Statement Presentation

- Entities must present qualitative and quantitative information about:
  - Contracts with customers
  - Significant judgments and changes in judgments
  - Revisions of estimates
  - Disaggregation of revenue
  - Assets recognized from costs to obtain or fulfill a contract

- Contract assets and liabilities should be presented at the contract level, not the performance obligation level

- Retention receivables

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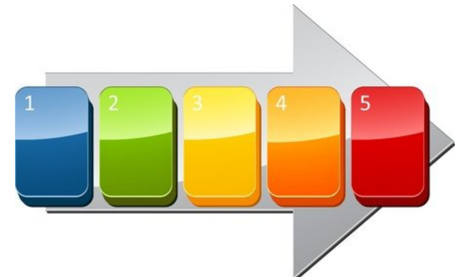
Disclosures: Internal Control Considerations

Disclosure of information not in accounting records

- Uncompleted contracts
- Changes in contracts: cumulative catch-up adjustments

Qualitative disclosures

- Significant estimates and judgments



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Implementation & Transition – Two Approaches

Retrospective Transition Method

- Apply Topic 606 to all prior periods presented
- Certain practical expedients are allowed

Cumulative Effect Method

- No restatement of prior periods
- An entity can choose to apply to only contracts that are not completed contracts at date of initial application or all contracts at date of initial application
- Recognize a cumulative effect adjustment at beginning of period
- Disclose in the year of adoption the effect on current year, by line item.

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Polling Question #4

Which transition method does your company plan to use when adopting the new revenue recognition rules?

A. Full retrospective
B. Cumulative effect method
C. Undecided

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Implementation Framework

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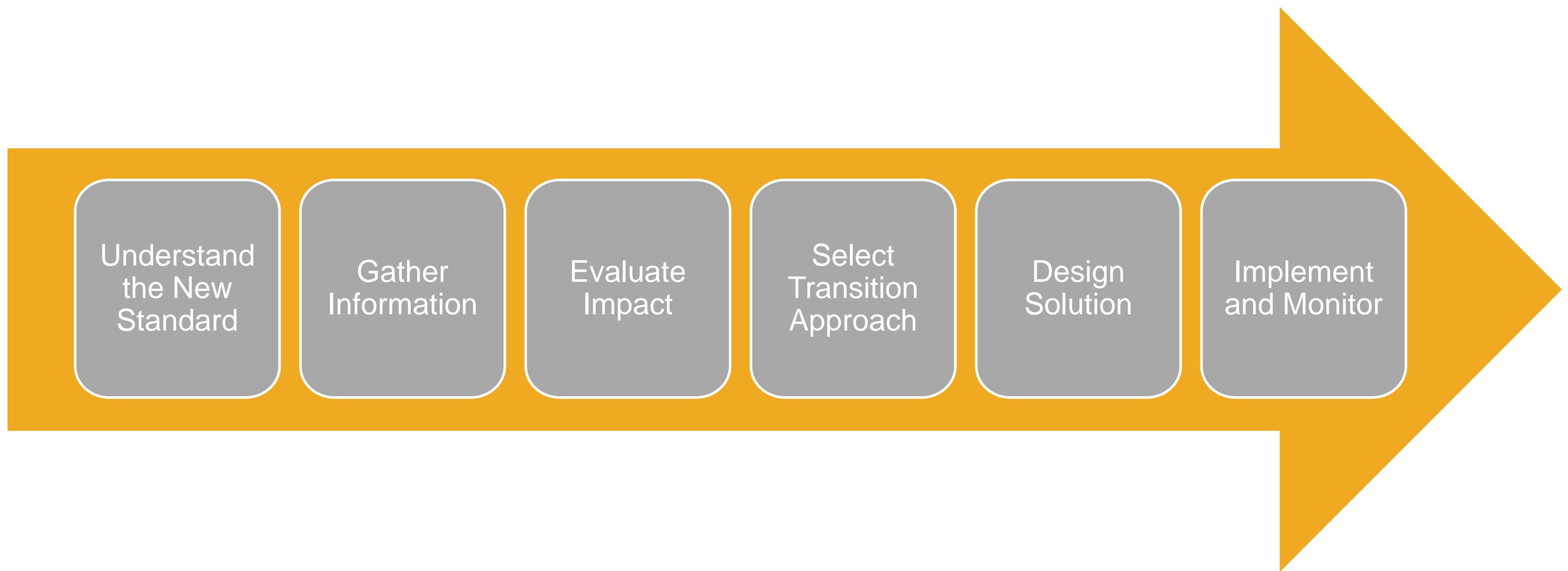
Implementation Framework



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Gather Information

Understand the New Standard | Gather Information | Evaluate Impact | Select Transition Approach | Design Solution | Implement and Monitor

- 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

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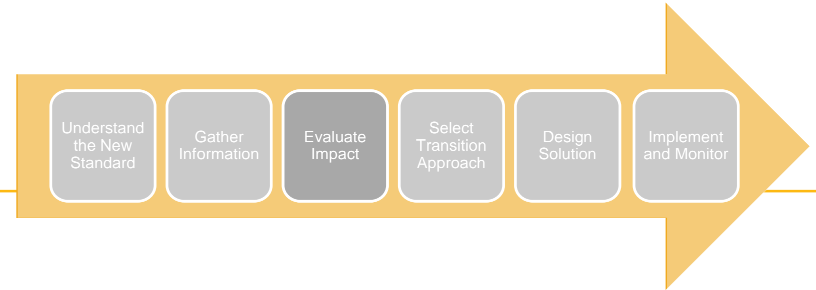
Evaluate Impact



- 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

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Evaluate Impact (cont.)

Understand the New Standard
Gather Information
Evaluate Impact
Select Transition Approach
Design Solution
Implement and Monitor

- Systems impact
  - If new performance obligations are identified, asses 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
- 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

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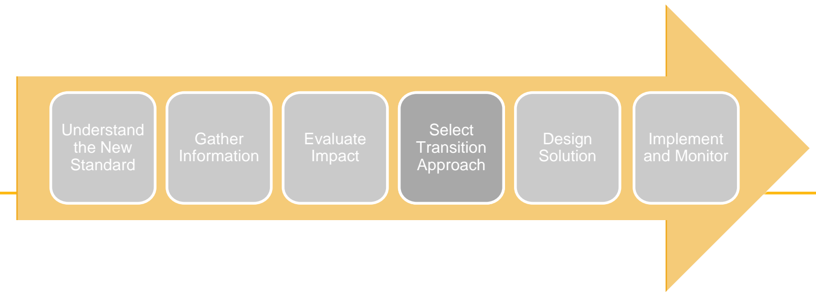
Implement Transition Approach



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

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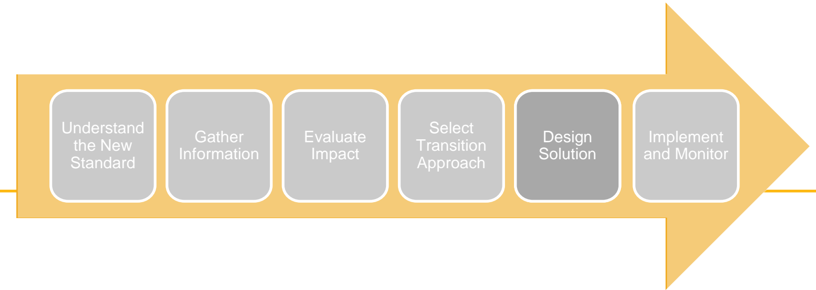
Design Solution



- 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

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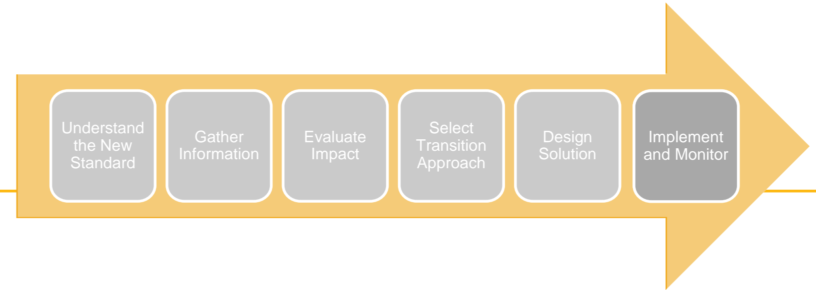
Implement and Monitor



- 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

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Thank you

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