ACCOUNTING TODAY. The Nuts & Bolts of the Changes in Revenue Recognition

GRASSI & CO. (July 25, 2018)

Over the course of the past few years, you may have heard rumblings about significant changes in our accounting guidance as it relates to how companies recognize revenue. The Financial Accounting Standards Board issued ASU Revenue From Contracts With Customers (Topic 606), which is effective for public business entities, beginning after December 15, 2017; and private companies for periods beginning after December 15, 2018. The spirit of the change is to create comparability amongst industries, regardless of geography, as how business is being conducted has drastically changed over the years.

The frequently asked question, as we rocket closer and closer towards implementation, has been, “what will the ultimate impact be, if any, to the construction industry as a result of these regulatory changes?” Let’s start by dropping the “if any”. Every construction company that enters into a contract and prepares their financial statements in accordance with generally accepted accounting principles (“GAAP”) will feel these changes. In some instances, the changes may be seismic, in others, it may be immaterial, but the changes will affect the construction contractors financial reporting.

Some of the key issues the construction industry needs to be aware of relate to how contracts may or may not be combined, assessing whether or not a project has singular or multiple performance obligations, waste and inefficiencies, and uninstalled materials, to name a few.

Combining Contracts

Under the current guidance, a construction company can combine or segment a contract if certain criteria are met; combination is also acceptable with two or more customerswhen certain criteria are met. However, the incoming guidance requires two or more contracts to be combined if the contracts are entered into **at or near the same time with the same customer** and one or more of the following conditions are met:

The contracts are negotiated with a single commercial objective;
The amount of consideration in one contract depends on the other contract;
The goods or services are a single-performance obligation.

As you can see these could be impactful changes as contracts with different customers may no longer be combined. Further combining contracts will occur when the price of a second contract is based on the advantages existing in the first contract. In addition, users should keep in mind that negotiating the contracts at the same time does not necessarily demonstrate a single arrangement.

There is no bright line in determination of “at or near the same time”, so the longer the period between entering into contract may indicate the economics have changed. A practical example: a construction company enters into a contract to complete the core and shell work on a 25-story building. One week later, the company enters into a contract to complete the interior fit out on the same building with the same customer as the core and shell work. Since the contract price of the second contract was likely impacted by the first contract, and the contracts were entered into near the same time with the same customer, they would be combined.

Performance Obligations

This term will become standard construction jargon going forward. A performance obligation is a promise in a contract with a customer to transfer a good or service to the customer, which is either explicit or implied. A contract will have multiple performance obligations if each is considered distinct. Performance obligations are identified at the contract’s inception and determined based on contractual terms and customary business practice.

What the construction financial managers and users need to reconcile is that identifying performance obligations, and how they are satisfied, will directly affect when revenue is recognized. The term distinct needs to be addressed in two lights within the performance obligation conversation. A performance obligation is **capable** of being distinct if the customer can benefit from the good or service on its own or together with other resources readily available to the customer or the customer can use the good or service with other readily available resources.

In addition, the performance obligation must be distinct **within** the contract. In other words, the promise to transfer a good or service from the other good or service **is stated in the contract**.

The following are indicators that two or more promises to transfer goods or services are notdistinct:

Highly dependent on, highly interrelated with other promised goods or services;
Doessignificantly modify other promised goods or services in the contract;
The contractor provides a significant service of integrating goods or services to provide a combined output contract by the customer.

A typical scenario for the construction industry is contracts for engineering, procurement and construction or design build projects—that have multiple services that must be evaluated to determine if the goods or services represent multiple performance obligations. Another common instance would consider the operation and maintenance portion—which, under the criteria described, would be a separate performance obligation from design/construction segment.

Let’s consider an example whereby a company enters into a contract to design and build an airport terminal. The company is responsible for the design and management of the project, including engineering, site clearance, foundation, and procurement, construction of terminal space, airline office space and installation of equipment and finishing. As all of these goods are interdependent and interrelated (the customer cannot benefit from each good on its own), the contract would be considered one performance obligation.

Waste & Project Inefficiencies

Reworking already completed items due to either wrong materials being used or faults in the craftsmanship, is not uncommon in the today’s building process. Under the existing standard, the cost of waste is considered a job cost, is rolled into the project and reported cumulatively. This accounting will change once the industry adopts ASU 606. Since the costs related to rework or wasted materials do not represent the transfer of goods or services to the customer, they would be excluded from input measurement. In other words, these types of costs do not contribute to progress in satisfying the performance obligation, and, therefore, the construction company would consider them a period cost and reflect them accordingly. The following is a work in process presentation under existing and incoming GAAP:

As you can see under the new standards, the waste/project inefficiencies costs are clearly segregated. With recovery uncertain and, again, considering that waste does not contribute to progress in satisfying the performance obligation, the impact is a lower percent complete under the cost-to-cost method—resulting in lower revenues recognized and gross profit (the overall costs incurred to date for the project remain the same).

Another wrinkle in the waste conversation revolves around how field personnel is noting and tracking any rework items so that accounting can track and report waste. Further, are accounting systems being updated for this, essentially, new cost category? While on the surface these issues could be perceived as minor carve outs, or perhaps something the construction contractor may conclude on any given project, is immaterial, but taken at the overall company level this could have a material impact.

Uninstalled Materials

A project often requires materials to be assembled in order to produce a combined unit of output (i.e. a single performance obligation). It is common for materials to arrive on the job site or at the shop in advance of the contractor’s ability to install. An item to consider under the changes ASU 606 isif a contractor is using cost-to-cost method, costs incurred may not be proportionate to the progress to satisfy performance obligation. Rephrased, if the contractor has obtained materials and they are not integrated into the project, does this inclusion of uninstalled materials in the percent complete calculation result in recording revenue prematurely?

Another “test” the contractor can apply is if the uninstalled materials related to a performance obligation immediately transfer into the control of the customer. If not, then those materials may qualify as inventory as the contractor could transfer the materials to another project. The opposite would hold true if the customer obtains control of the materials before installed, then they would not be considered inventory. However, if the customer does obtain control but the material is not integrated into the overall project, these costs should be excluded from the measure of progress; the contractor would record the uninstalled materials at zero profit (revenue = costs incurred).

The following example assumes a construction project has incurred $200,000 of materials for which control has transferred to the project owner but remain uninstalled at the job site. As you can see under the existing standard, the costs and associated gross profit would be included in the percent complete calculation. The new standard will require the contractor to report the uninstalled materials as a separate line item with no profit recognition. The impact here is close to 10% of the project’s progress, which translates to reporting close to $21,000 less gross profit.

Much like the waste conversation above, internal controls must be established to track the transfer of control of materials and materiality will play a role in the assessment. In summary, **YES** there are going to be changes in your GAAP revenue recognition model and the construction industry will be affected. I would challenge anyone otherwise; these changes are real and are here. As conceded earlier, the impact could affect some sub-segments of the construction industry more than others. There are certain takeaways of this dialogue, I urge you to consider:

The percentage of completion model based on an input method, such as cost-to–cost, which is common place today, will still be an available revenue recognition model but will need to be assessed for suitability;
Examine and evaluate your current internal control structure to develop fact patterns for certain types of typical contracts, which will enable you in the determination of performance obligation;

There will be new comprehensive disclosure requirements that are expected to provide users of the financial statement with detailed information regarding the construction company’s revenue recognition;
Continue to educate yourself and your accounting and project personnel. This is one of many disruptors in the financial landscape today so the more information you gather and apply to your situation, the less of a financial impact the adoption will have on your company.

Please note this article is not all-inclusive as there are other considerations under ASU606: Revenue From Contracts With Customersto be addressed in future installments.

Carl Oliveri, CPA, CCIFP, CFE, is a Partner and Construction Practice Leader at Grassi & Co. For more information on these and other changes, you can reach Carl directly at coliveri@grassicpas.com.

Links
[1] http://iitaly.org/files/revenuejpg-1