REVENUE RECOGNITION STANDARD

CONTRACTORS

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09 – Revenue from Contracts with Customers (Topic 606) which attempts to clarify the principles for recognizing revenue. Although the ASU was issued in 2014, the FASB provided a long implementation period. For entities that are not considered public business entities (PBEs), the standard becomes effective for annual reporting periods beginning after December 15, 2018, which means January 1, 2019 for calendar year-ends.

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SO WHAT CHANGED?

The recognition of revenue under current accounting standards requires the consideration of two factors; being realized or realizable and being earned. FASB believes ASU 2014-09 will significantly enhance the comparability of revenue recognition practices while also providing a framework to ensure the guidance remains relevant. Specifically, the core principle of ASU 2014-09 is "that an entity should recognize revenue 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." To achieve the core principle, ASU 2014-09 provides a list of steps to be taken.

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

Each entity will apply this five-step approach to determine when revenue and gains included within the scope of the standard should be recognized.

STEP ONE

For step one, you have to identify if there is a contract in place, which is pretty typical already for contractors. The contract has to have approval from all parties involved (which can be verbal) and creates enforceable rights and obligations. It needs to have commercial substance and be probable that the consideration will be collectible at the time of the contract inception. It will be important to watch for contracts that have termination clauses with no penalties—this is where judgement will come into play to consider if the contract is likely to be collectible with that type of clause. The amount to which the entity may ultimately be entitled may actually be less than the stated price in the contract (in cases of price concessions).

STEP TWO

Step two is where judgement will really come into play. For step two, you have to identify the performance obligations in the contract. A contract may have distinct separate performance obligations (a good or service or a bundle of goods or services) or it may have multiple obligations that have a similar pattern of transfer to the customer and can be grouped together and treated as one performance obligation. To be considered distinct, the good or service has to provide the customer benefit on its own or with other resources that are readily available to the customer and the promise to transfer the good or service to the customer is identifiable separately from other promises in the contract. An example of grouping services would be building a house—there are many separate tasks such as drywall, electrical, plumbing, etc. that may all provide benefit individually but ultimately combine to fulfill the contracted task of building a house. The separate tasks are not considered a distinct part of the contract. There is one performance obligation there—to build the house. Revenue is recognized as performance obligations are completed. At contract inception, you will need to determine if the performance obligation is satisfied at a point in time or over time.

STEP THREE

For step three in determining transaction price, it is usually stated in the contract, but judgement again may need to come into play when there are items of variable consideration. Examples could be unpriced change orders or performance bonuses. When determining the contract price, you will want to factor in the price (using an estimate) of the variable components if it is probable that it will occur and will not be reversed (if you were to record the revenue). For example, if you feel you will achieve a performance bonus, you would include that amount in your price to recognize. Any noncash consideration would be estimated at its fair value at the date of the contract inception. Another noteworthy item to consider in determining the price is how to treat tax related items—an entity can make an accounting policy election to exclude taxes from the transaction price if they wish.

STEP FOUR

For the fourth step, the total transaction price is allocated to each performance obligation on a standalone selling price basis (which is what you could sell that good or service for separately in similar circumstances to similar customers). If you don't know what the performance obligation would be on a stand-alone basis, you will need to estimate it. Besides doing an analysis of what it would sell for to other customers in a similar situation, you could take an expected cost plus a margin approach (costs of satisfying the performance obligation with an appropriate margin allocated to it). Another method to determine the price is using a residual approach (which is only used if you absolutely cannot determine a standalone price or if the price of that deliverable sells for a wide variety of amounts). The residual approach would be where the company takes the total contract price and backs off all of the other known costs.

STEP FIVE

For step five, contractors can continue to recognize revenue using the percentage of completion method. Revenue should normally be recognized at a point in time but should be recognized over time for contractors since the customer is typically controlling the asset as it is created or enhanced (for example, if you are constructing on the customer's land, the land is being enhanced while completing the project on it).

SOME NOTEWORTHY ITEMS

CHANGE ORDERS

A change order or contract amendment could be treated as a new separate contract if the scope of the contract increases due to the addition of distinct promised goods or services **and** if the contract price increases by an amount that reflects standalone selling prices of the additional items/services added to the contract. If you deem it is not a separate contract, you would need to treat the prior existing contract as if it were terminated and the change order as a new contract (if the remaining services/goods left in the original contract are distinct from the items [goods/services] transferred prior to the contract modification). The amount of consideration to be allocated then is the consideration promised by the customer (you will need to include amounts already received from the customer) in the original estimate that has not yet been recognized as revenue in addition to the consideration from the contract modification or change order. The change order is now treated as part of the existing contract as long as it is not deemed to be a separate performance obligation. The adjustment to revenue is made on a cumulative catch up basis (using revised revenue estimate total in the measurement of progress toward completion).

RETAINAGE

Contractors cannot consider retainage a receivable now. This should now be classified as costs in excess of billings. You may want to take a look at this to determine if it could potentially affect any financial ratios/debt covenants.

UNINSTALLED MATERIALS

Uninstalled materials should be backed off of your costs when determining your percent complete (for example, if you have an uninstalled elevator, you would back that off of costs incurred and back it off of the total expected cost amount to determine your percent and multiply it by the transaction price of the contract less the elevator cost to come up with your revenue. The revenue would be that calculated amount plus the full cost of the elevator).

MOBILIZATION COSTS

These costs will now be treated differently, as well. If contractors bill and collect for these costs in advance, they should be capitalized and amortized over the duration of the contract (these aren't considered a cost of fulfilling the contract performance obligation but are deemed more as a contract fulfillment cost and should not be factored into the costs for percent complete).

PRECONTRACT COSTS

Costs to obtain a contract are recorded as an asset and amortized similarly to mobilization costs. These costs may just be expensed though, if the period of the asset is one year or less.

If you have any questions regarding the revenue recognition standard (ASC 606) please contact us.

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