5 STEPS CONSTRUCTION CONTRACTORS NEED TO KNOW FOR THE NEW REVENUE RECOGNITION STANDARD

ACCOUNTING PROPHETS HAVE BEEN WANDERING THE GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAP) WILDERNESS THE PAST SEVERAL YEARS, PROCLAIMING THE END OF REVENUE RECOGNITION AS WE KNOW IT.

However, revenue recognition standards are anything but standard across industries. To allow for comparison of revenues across industries, the Financial Accounting Standards Board (FASB) introduced a five-step model (ASC 606). The wisdom of this is debatable, but it's here now, and it's a part of GAAP. For non-public companies, it is effective for reporting periods beginning after December 15, 2018, or for 2019 calendar year reporting.

Construction contractors have long recognized revenue using the cost-to-cost percentage-of-completion method. For some contractors, the new standard may require little change, but one thing it will certainly do is introduce judgment. As with most new standards, we believe that the new disclosure requirements and implementation will require more effort than expected, even if the measurement aspects are not significant.

Because of this, management should examine the nuances of the standard prior to implementation, rather than on the fly or after the fact. Below are several considerations based on the five step model that we believe should be adapted. These considerations are not meant to be a comprehensive discussion of the issues—every contract and contractor is different. Rather, this is meant to be a tool to start the thought process about the implications.

Step 1: Identify the Contract

- For most contractors, this should not be difficult given the environment in which they operate. Contracts may be written or oral, but must be identifiable, have commercial substance, and be probable that consideration will be collected.
- Unilateral termination clauses without significant penalties for termination may bring into question whether an actual contract exists.

Question to consider:

- Is collection of the consideration on all our contracts probable? Are there termination clauses that are unilateral without significant penalties?

Step 2: Identify the Performance Obligation

This step will most likely be the most challenging and will require some judgment by management. Interpretations will vary.

A performance obligation is a distinct good or service provided by a contract. If there are other promises in a contract that are different, or can be distinguished from others, a more thorough analysis should be performed. Multiple performance obligations should be treated as separate contracts, even if they exist in one contract with the customer.

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- Change orders are considered separate contracts if, 1) they increase scope to provide for additional promised goods or services to be delivered that are distinct (a separate performance obligation), and 2) the increase in contract value reflects the contractor's estimated additional costs.
- Series contracts (for example, a contract to replace a roof for a group of buildings) may be treated as one performance obligation given that the services provided are substantially the same. If the buildings have different circumstances (for example: scope, access, mobilization), the performance obligations must be separated.
- Assurance warranties will typically be included with the original contract. Service warranties (for example, installation plus quarterly check-ups) may need to be separated into performance obligations.

Questions to consider:

- Do our contracts include multiple, distinct promises of goods or services? Are there separate performance obligations?
- Do our contracts include service warranties, and should those be treated as separate contracts?
- Do we have a process to review change orders to ensure that we are accounting for them correctly?
- If we have multiple performance obligations, do we have the proper procedures in place to track the costs and revenues separately? Does our accounting system have the ability to track them?

Step 3: Determine the Transaction Price

- Typically, contract prices are stated in the contract and are straightforward. However, should the contract include variable consideration (performance bonuses, safety bonuses, liquidated damages, unapproved/unpriced change orders), contractors will need to estimate the amount of variable consideration to include in the contract value when known and probable to occur.

Question to consider:

- Do our contracts include any variable consideration clauses, and what are the probabilities that these will be earned/lost?

Step 4: Allocate the Transaction Price

- Should only one performance obligation be identified in step two above, step four should not be complicated. However, if multiple performance obligations were identified, the most reasonable allocation method will be to allocate the contract price based on how the contract was bid.

Question to consider:

- Do we have multiple performance obligations?

Step 5: Recognize the Revenue

- Revenue will still be recognized utilizing the same cost-to-cost percentage-of-completion method, consistent with current GAAP.

Question to consider:

- Do we have multiple performance obligations and a system to adequately track costs?

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Other Considerations

- Under the new standard, certain costs that are recoverable should be capitalized and expensed over the life of the contract, if the contract is expected to exceed one year. Costs include incremental costs of obtaining a contract, such as sales commissions, bond premiums, and mobilization costs.
- Uninstalled materials should be excluded when measuring progress on a contract. For example, a building contract which includes a significant elevator installation. If the elevators are ordered and delivered to a job site, but not installed at year end, this cost must be excluded when determining the percent complete on other aspects of a job.
- Significant inefficiencies will be excluded from the completion calculation of a contract.
- Retention will be classified as costs in excess of billings rather than under accounts receivable.
- The IRS has not indicated that they will follow the new standard at this moment. This may result in book-tax differences.
- When adopted, differences in current GAAP and this standard for contracts in progress at adoption will be posted directly to equity, which may result in revenue never being recognized or double counted.

Steps to Take Now:

1. **Read and inventory your contracts.** Pay special attention to different performance obligations or variable consideration arrangements.
2. **Ensure that procedures exist** and the accounting system is capable of tracking costs separately should multiple performance obligations exist.
3. **Ensure that sales staff and other individuals** authorized to enter into contracts are educated on the new standard.
4. **Ensure that procedures exist to identify multiple performance obligations** before work begins, so that costs can be tracked separately.
5. **If entering into contracts that will span through 2019**, begin to map out the differences in revenue recognition for budgeting and reporting purposes.

This revenue apocalypse may be no more than a blip on the evolution of GAAP from rules-based to principles-based. At the very least, it will introduce judgment and subjectivity, and in turn, financial reporting risk. As a result, management should start evaluating the implications now.

Should you have any questions or would like to discuss implementation of the standard further as it relates to your business, please do not hesitate to contact your local Sikich advisor or visit www.sikich.com. We are here to partner with you and guide you through these issues.

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