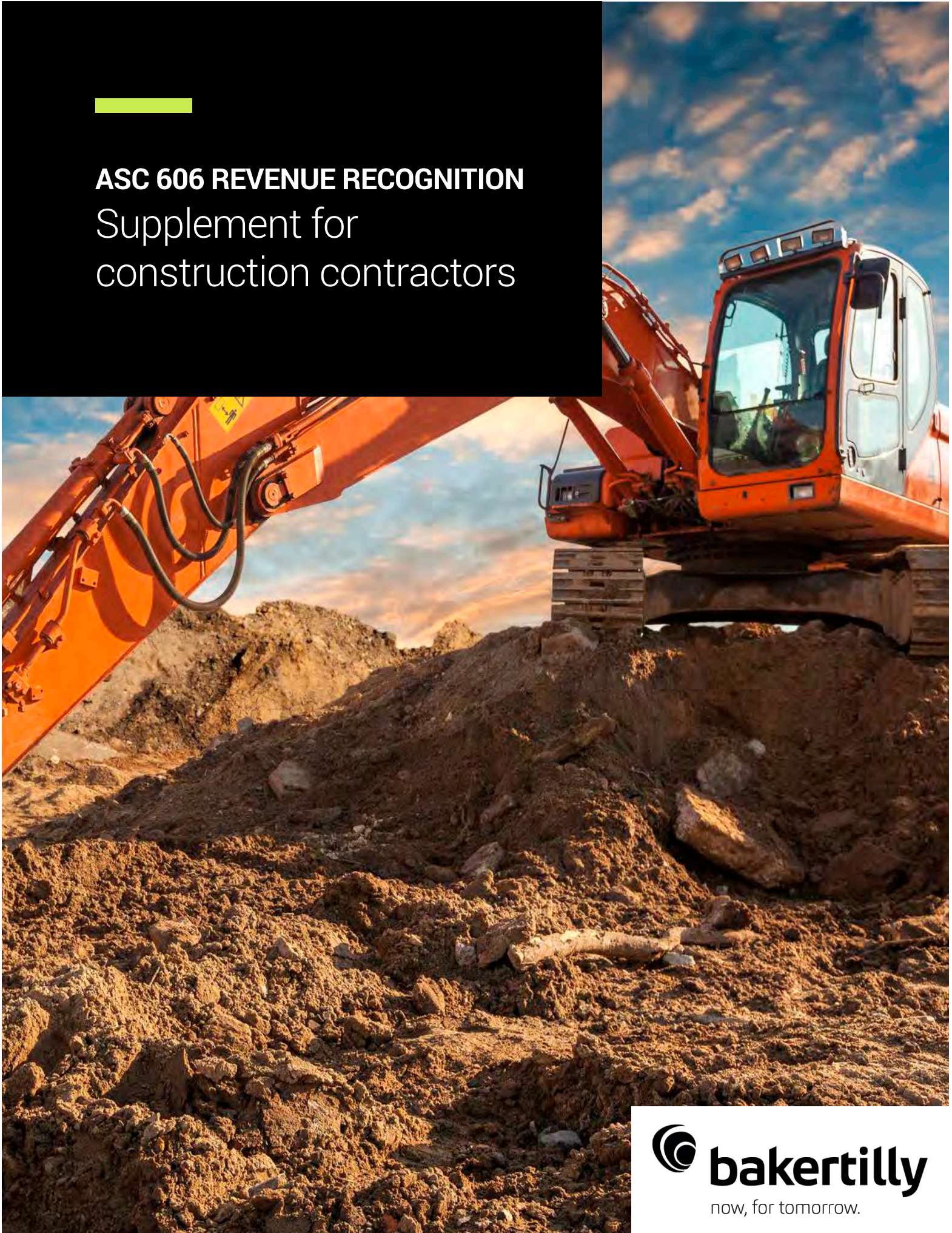


ASC 606 REVENUE RECOGNITION
Supplement for
construction contractors



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INTRODUCTION

Construction contracts by nature are long-term and often require changes in the specific terms once the project is underway. Recognizing revenue at different times can affect financial metrics and tax planning. Each revenue stream and contract or contract type must be assessed to understand how the new standard will impact it, and this assessment will be a complex process. Some companies may even want to change certain business practices or parts of their contracts to better align with the standard.

Construction companies must apply the new standard and document the decision making process, with significant financial statement disclosures required for those decisions. Even if there is no change in top line revenue, there may be a difference in the accounting process to reach that number. For many, there will be substantial changes to business systems, processes and internal controls over financial reporting.

Baker Tilly can help. Our specialized professionals use a **six step methodology** to aid you in assessing the impact, developing a plan and implementing this plan across your organization.

It is our pleasure to provide this supplement of construction-specific insights and sample scenarios to our comprehensive eBook to help you understand revenue recognition. We trust you will find value in the information presented.

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IDENTIFYING THE CONTRACT

The first step in applying Accounting Standards Codification (ASC) 606 is to identify the contract(s) with the customer. To do so, you must evaluate indicators of the existence of the contract. These contract requirements are usually already evident in written contracts in the construction industry; however, the new accounting standard requires additional judgment, evaluation and documentation related to the collectability and the commitment to satisfy the customer's obligations.

Collectability

One of the necessary elements of a revenue contract under ASC 606 is that the consideration specified in exchange for the goods or services be collectible. Contractors will be required to perform an assessment of the customer's **ability and intent** to pay the agreed upon consideration at the inception of the contract. The collectability requirement is applied through the lens of the probability concept, which means the future event (payment) is likely to occur. Under U.S. GAAP, the likelihood of the future event occurring must be at least a 75 percent chance of occurring.

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Contractors with well-designed and implemented internal controls, policies and processes related to granting credit to customers should be able to apply the new standard without significant changes. Potential policies and processes related to assessing the collectability of consideration could include obtaining, reviewing and analyzing a project owner's financial statements, financing commitments or proof of funds.

A scenario in construction

A contractor enters into a construction contract to build-out tenant space for a start-up company. The consideration agreed to under the construction contract is \$1 million. The company does not have historical financial statements and is in the process of raising capital to fund its operations and the cost of construction. The company has a financing commitment from a financial institution totaling

\$500,000. The company has prepaid \$200,000 to the contractor. The balance of the consideration to be paid under the construction contract is planned to be funded from capital raised by the company. The contractor has agreed to commence with construction with an understanding that the full amount of consideration may not be received until such time the start-up company has raised sufficient capital, which is potentially inconsistent with the transferred control of goods or services.

Conclusion

In this situation, the contractor is likely to conclude that there is too much uncertainty about the start-up company's ability to pay the full amount of the consideration agreed to under the construction contract. As such, there is not a valid contract. The amount of the prepaid deposit of \$200,000 should be recorded as deferred revenue and costs of construction should be recorded as prepaid construction costs until such time that future collection becomes probable and the collectability threshold has been met.

Combining contracts

Under existing U.S. GAAP, a contractor had the ability but not the requirement to combine contracts. Under ASC 606, contracts will be required to be combined when certain criteria are met. The new accounting standard requires contracts be combined prior to further assessment of the five elements, if one or more of the following criteria are met:

- Negotiated at the same time with the same customer (or related party) with a single commercial objective in mind
- The consideration to be paid for one contract is dependent on another contract
- The promised goods and services in the contracts are a single performance obligation in accordance with the guidance

A scenario in construction

A design-build construction firm is negotiating the design and construction contracts for a commercial office building. The firm submits a bid to the project owner on January 15, 2018 for the design services totaling \$500,000. The firm submits a bid to the project owner for construction services on January 30, 2018 totaling \$8.5 million. The firm includes a provision in its construction services bid that indicates its bid price for construction services is contingent upon the project owner's acceptance of the design services contract. Without the acceptance of the design services contract, the construction services bid price would be \$8.75 million. The project owner accepts the design and construction services bids on February 15, 2018 and enters into the contracts totaling \$9 million.

Conclusion

The design and construction services contracts between the design-build firm and the project owner were negotiated at approximately the same time, with a single commercial objective in mind (the design and construction of a commercial office building). The amount of consideration to be paid by the project owner for the construction services is contingent on the acceptance of the consideration to be paid for the design services. The design and construction of a commercial office building is considered a single performance obligation in accordance with the guidance in the standard, since the goods or services are highly interdependent and interrelated. In this example, the criteria identified in the standard have been met. Accordingly, the total contract price of \$9 million must be allocated to the design and construction contracts in amounts that differ from the contract price in the individual contracts.

Contract modifications or change orders

Contract modifications or change orders are extremely common in the construction industry. ASC 606 requires additional judgment and documentation when determining how to properly account for a contract modification. A contract modification must change the scope or price (or both) originally agreed by the parties. The modification can be written, oral, or in accordance with customary practice as long as it has commercial substance. A modification can also occur when both parties have agreed to the scope change, but not the price. When that occurs, the contractor must estimate the consideration it expects to receive in accordance with guidance on variable consideration.

...A contract modification must change the scope or price (or both) originally agreed by the parties.

The new accounting standard provides a number of prescribed methods to account for modifications including 1) as a separate contract; 2) as a termination of the original contract and creation of a new contract; or 3) as part of the existing contract.

Contract modifications are accounted for in two ways, either as a separate contract or as modification to the original contract, depending on the following guidance:

Separate contract:

- The scope of the contract changes due to the addition of promised goods or services that are distinct; and

- The price of the contract increases by an amount of consideration that reflects the contractor's standalone selling price.

Modification (the changes are not accounted for as a separate contract):

- A contractor shall account for the contract modification as if it were a termination of the existing contract and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification and the consideration does not reflect the standalone selling price. The revenue recognized to date on the original contract (i.e. the amount associated with the completed performance obligations) is not adjusted. Instead, the remaining consideration from the original contract is combined with the additional consideration promised in the modification to create a new transaction price, which will be accounted for on a prospective basis that is allocated to all remaining performance obligations.
- A contractor shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the contractor's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).
- If the remaining goods or services are a combination of the two preceding paragraphs, then the contractor would not adjust the accounting for completed performance obligations that are distinct from the modified goods or services (consistent with the prospective basis). However, the contractor would adjust revenue previously recognized to reflect the effect of the modification

on the estimated transaction price allocated to performance obligations that are not distinct from the modified portion of the contract and measure of progress (consistent with the catch-up basis).

Example of a separate contract

An aggregate mining contractor entered into a contract on March 15, 2017 to provide 100,000 tons of aggregate materials to a governmental entity to be used for road maintenance at a price equal to \$5.00 per ton, which is to be delivered with transfer of control over a period of 6 months. On July 15, 2017, the contractor has delivered 75,000 tons of aggregate materials under the original contract and the governmental entity has requested the contractor provide a bid for an additional 50,000 tons of aggregate materials, which is to be delivered with transfer of control over a period of 3 months from the contract modification date. The contractor's bid of \$4.00 per ton for the additional 50,000 tons of aggregate materials is reflective of the standalone selling price based on observable transactions with unrelated customers at the time of the bid which was approved by the governmental entity.

Conclusion

The delivery of the additional 50,000 tons of aggregate materials is considered to be a distinct good and the price represents the contractor's standalone selling price. This contract modification or change order should be accounted for as a new and separate contract. Revenue on the remaining 25,000 tons of aggregate materials under the original contract should be recognized at \$5.00 per ton and revenue from the contract modification should be recognized at \$4.00 per ton as the transfer of control occurs and the performance obligations have been satisfied.

Example of a modification resulting in a new and separate contract

A general contractor was awarded a contract to build a new school for \$100 million. After construction has started, the customer approves a modification for an additional gym to be built on the school grounds. Both the contractor and the customer agree to modify the contract to include the construction of the gym for

a total price of \$105 million, to be completed within six months. Based on similar contracts, the general contractor would normally charge \$5.2 million to build the gym; however, the contractor expects to take advantage of various efficiencies at the job site, given that most of the equipment and labor resources necessary for the additional build-out are already on site. Accordingly, the \$5 million reflects the standalone selling price of the additional service to be provided at the date of the modification.

Conclusion

The modification for the build-out of an additional gym is considered to be a distinct service that increases the scope of the contract. The additional consideration (adjusted for the specific circumstances of this particular contract, regarding the available resources on site) is considered to be the standalone selling price. As such, the contract modification for the gym build-out is accounted for as a new and separate contract that does not impact the accounting for the existing contract, given that both required factors are met.

Example of a modification resulting in a cumulative catch up

A general contractor enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of \$1 million and a bonus of \$200,000 if the building is completed within 24 months. The contractor has determined that the goods and services to be provided are a single performance obligation satisfied over time because the customer controls the building during construction. At contract inception, the general contractor expects to attain 30 percent gross profit on the contract excluding the performance bonus. The general contractor has determined that the completion of the building is highly susceptible to factors outside their ability to influence, including weather and regulatory approvals. In addition, the general contractor has limited experience with similar types of contracts. As a result, the general contractor has excluded the \$200,000 bonus from the transaction price.

At contract inception, the general contractor expects the following:

Transaction price	\$1,000,000
Expected costs	\$700,000
Expected profit (30%)	\$300,000

At the end of year one, the general contractor has satisfied 60 percent of its performance obligation on the basis of costs incurred to date relative to total expected costs. The general contractor has reassessed the variable consideration and concludes that the amount is still constrained. Consequently, the cumulative revenues and costs recognized for the first year are as follows:

Revenues	\$600,000
Costs	\$420,000
Gross profit	\$180,000

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. The contractor determined that the goods and services included in the modification are not distinct. As a result, the fixed consideration and expected costs increase by \$150,000 and \$120,000, respectively. In addition, the allowable time for achieving the \$200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of the contractor’s experience and the remaining work to be performed, the contractor concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized.

Conclusion

The contractor determined that the change order for the modified floor plan is not distinct from the original contract, so the original contract remains a single performance obligation. Additionally, the contractor now believes it is probable it will complete the project within the 30-month bonus period. Accordingly, the contractor includes the full \$200,000 bonus in the contract amount and recognizes a catch-up adjustment (accounted for as a change in estimate) in year two.

The calculation below illustrates the amount of the catch-up adjustment recognized in year two:

	Year Ended 12/31/20X1	As Adjusted Year Ended 12/31/20X1
Cost incurred to date	\$420,000	\$420,000
Estimated total costs	\$700,000	\$820,000
Percent complete	60.0%	51.2%
Transaction price	\$1,000,000	\$1,350,000
Revenue earned to date	\$600,000	\$691,463
Less: Revenue earned in prior period	-	(\$600,000)
Revenue earned in current period	\$600,000	\$91,463

IDENTIFYING PERFORMANCE OBLIGATIONS

Once a construction contractor has determined that it has a contract with a customer, as defined by ASC 606, the second step in applying the new accounting standard is to identify the performance obligations within the contract(s). The identification of separate performance obligations under the new accounting standard requires additional judgment related to the concept of a **distinct good or service**, the identification and evaluation of promises in contracts with customers, and the evaluation of principal versus agent considerations.

Performance obligations

A performance obligation, as defined in ASC 606, is a promise to deliver a good or service (or a bundle of goods or services) that is **distinct**, OR a series of **distinct goods or services** that are substantially the same and have the same pattern of transfer to the customer. To identify performance obligations, a contractor needs to determine whether or not the goods or services are distinct. The complexity arises in evaluating the promise(s) in the contract and determining whether they should be accounted for separately or together. This process directly affects the timing of revenue recognition.

A good or service is distinct if the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct) **AND** the contractor's promise

to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

A good or service is not distinct if it is highly interdependent and interrelated, and the contractor will combine that good or service with other promises until it identifies a bundle that is distinct. This may result in the contractor accounting for all the goods or services promised in a contract as a single performance obligation.

The majority of construction contracts provide goods or services that are highly interdependent and interrelated, which would result in the contract being a single performance obligation; however, customer options for additional goods or services that provide material rights to the customer and service-type warranties are likely to be separate performance obligations.

A scenario in construction

A contractor enters into a contract with a customer to install an HVAC system. The contractor manufactures the ductwork for the system and purchases additional HVAC equipment from other vendors. The contractor does not design or manufacture the purchased HVAC equipment, but it does install the equipment in the customer's facility. The construction contract includes

a one-year preventive maintenance agreement at no additional charge to the customer. The contractor regularly contracts with other customers to provide preventive maintenance services.

Conclusion

The contractor evaluates the contract terms and determines that there are four goods or services that are capable of being distinct: the installation services, the manufacturing of ductwork, the purchase of HVAC equipment and the maintenance agreement. The contractor concludes that the installation services, manufactured ductwork, and purchased HVAC equipment should be combined into one performance obligation because the contractor provides significant services of integrating the three items into the customer's facility. The contractor would also conclude that the maintenance agreement is a separate performance obligation since the customer can benefit from this service separately and it is not highly integrated with the installation services.

Promises in contracts with customers

A contract with a customer can be written or oral as long as it has commercial substance. In most circumstances, a contract with a customer explicitly states the goods or services that the construction contractor promises to transfer to a customer. However, the promised goods or services identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. A contract with a customer may also include promises that are implied by a construction contractor's customary business practices, published policies or specific statements made when entering into the contract.

A scenario in construction

A contractor enters into a contract with a customer to build a commercial office building. The contractor manages and supervises the construction project, self-performs certain trades and utilizes subcontractors to perform other trade services. The contract includes a one-year warranty covering defects in workmanship.

Certain building components are covered by a two-year warranty with the product manufacturer. Though not explicitly stated in the contract, it is a customary business practice for the contractor to perform 3-month, 6-month, 12-month, 18-month and 24-month walkthroughs with the project owner to identify defects in workmanship and building components. In addition, the contractor will assist the project owner in submitting claims of defect with the subcontractors or filing building component warranty claims.

...A contract with a customer may also include promises that are implied by a construction contractor's customary business practice.

Conclusion

The contractor evaluates the contract terms and determines that there are multiple goods or services that are capable of being distinct, including the self-performed and subcontracted trade work, the project management and supervision services, the one-year warranty, and the follow-up walkthroughs. The contractor concludes that the self-performed and subcontracted trade work, the project management services, and the supervision services should be combined into one performance obligation because the contractor provides significant services of integrating those items to construct the commercial office building. The contractor would conclude that the one-year warranty, the walkthroughs and the assistance in submitting claims of defect would be separate performance obligations since the customer

can benefit from these services separately and they are not highly integrated with the construction of the commercial office building.

Principal versus agent considerations

To properly identify and account for performance obligations when other parties are involved in providing goods or services to a customer, a construction contractor must determine whether its performance obligation is to provide the good or service itself (i.e., the contractor is the principal) or to arrange for another party to provide the good or service (i.e., the contractor is an agent). The determination of whether the contractor is acting as principal or agent will affect the amount of revenue recognized by the contractor.

When a contractor is determined to be the principal, the revenue recognized is the gross amount to which the contractor expects to be entitled.

When a contractor is determined to be the agent, the revenue recognized is the net amount to which the contractor is entitled to retain in return for its services as the agent.

The determination of principal versus agent is not always clear. The new standard provides these indicators of when a performance obligation involves an agency relationship:

- Another party is primarily responsible for fulfilling the promise to provide the specified good or service
- The contractor does not have inventory risk before or after the goods have been ordered by a customer, during shipping, or on return
- The contractor does not have discretion in establishing prices for the other party's goods or services, and therefore the benefit that the contractor can receive from those goods or services is limited

- The contractor is not exposed to credit risk for the amount receivable from a customer in exchange for the other party's goods or services

Example of acting as the principal

The construction of a manufacturing facility requires air handling equipment with unique specifications. The contractor works with the customer to develop the specifications for the equipment, which the contractor communicates to a supplier and the contractor enters into a subcontract agreement with that supplier. After agreeing on the equipment specifications and the scope of the work, the contractor and the customer agree to a price for the equipment. The contractor arranges to have the supplier deliver the equipment directly to the customer. Upon delivery to the customer, the terms of the contract require the contractor to pay the supplier the price agreed to for manufacturing the equipment. The contract between the customer and the contractor requires the customer to seek remedies for defects in the equipment from the supplier under the supplier's warranty; however, the contractor is responsible for any corrections to the equipment required resulting from errors in specifications.

Conclusion

The contractor evaluates the contract terms requiring the procurement and delivery of the specialized air handling equipment and determines that the contractor is acting as the **principal** in this scenario. The contractor concludes that it has promised to provide the customer with specialized equipment. Although the contractor has subcontracted the manufacturing of the equipment to the supplier, the contractor concludes that the development of the specifications and the manufacturing of the equipment are not distinct because they are not separately identifiable.

The contractor is primarily responsible for fulfilling the promise to provide the specialized equipment by determining the specifications, communicating those specifications with the supplier, entering into a supplier agreement to provide the equipment including the negotiation of price directly between

the contractor and supplier and, thus, provides a significant service of integrating those items into the specialized equipment. In addition, these activities are highly interrelated and as a result the contractor concludes that it controls the specialized equipment before it is transferred to the customer.

In the scenario, the contractor agreed to the scope and pricing with the customer and was exposed to credit risk for the amount receivable from the customer in exchange for the specialized equipment. As a result, the contractor would recognize revenue equal to the amount agreed upon with the customer for the equipment and recognize costs in an amount equal to the terms agreed upon in the subcontract with the supplier on a gross basis.

Example of acting as the agent

A contractor enters into a construction contract with a healthcare entity to build a new medical clinic. The medical clinic requires a specific scanner. The contract terms between the contractor and the customer indicate that the customer is responsible for the specifications, price negotiation and installation of the scanner by a supplier; however, the contractor is responsible for procuring the equipment and ensuring the building space can accommodate the equipment. The contract terms allow the contractor to include the cost of the equipment in its computation of general conditions and contractor profit.

Conclusion

The contractor evaluates the contract terms requiring the procurement of the equipment and concludes that it is acting as the **agent** in this scenario. The contractor determines that the scanner supplier is primarily responsible for fulfilling the promise to manufacture, deliver and install the equipment based on specifications provided by the customer. The contractor provides no significant service of integrating the equipment into the overall construction of the medical clinic.

As a result, the contractor concludes that the good or service is distinct and a separate performance obligation under the contract with the customer. In addition, the customer is responsible for negotiating the price with the supplier and therefore the benefit the contractor can receive from the procurement of the good or service is limited to its general conditions and profit percentages as defined in the contract. Therefore, the contractor would recognize revenue equal to the amount agreed upon with the customer for general conditions and profit related to the cost of the equipment on a net basis.

DETERMINING THE TRANSACTION PRICE

After identifying the contract and the performance obligations within the contract, the next step for a construction contractor under ASC 606 is to determine the transaction price. The transaction price is the amount of consideration to which the contractor expects to be entitled in exchange for satisfying its performance obligations, excluding amounts collected on behalf of third parties (i.e., sales tax).

In the construction industry, the transaction price is generally the contract price under the terms of the contract and may include fixed amounts, variable amounts or both. Determining the transaction price under the new standard requires contractors apply judgment and document processes and controls related to variable consideration, non-cash consideration and the existence of a significant financing component.

Variable consideration

When the consideration promised in a contract includes a variable amount, a contractor is **required** to estimate the amount of consideration to which it will be entitled. Variable consideration may include items such as discounts, rebates, credits, incentives, performance bonuses, penalties or other incentives that are unknown at contract inception. Amounts are only included in the transaction price if it is **probable** that a significant reversal in the amount of cumulative revenue recognized will not occur in the future.

To the extent that variable consideration is probable (generally at least a 75 percent chance of occurring) that a significant reversal in the amount of cumulative revenue recognized will not occur in the future, a contractor should estimate the amount of variable consideration using either the **expected value** or **most likely amount** methods to determine the amount of variable consideration to include in the transaction price. The method a contractor selects is not a policy choice; the estimation is driven by the facts and circumstances of each contract. The chosen method should be applied consistently throughout the contract and throughout contracts with similar terms and requires documentation of management's conclusions. The estimate used at contract inception should be revisited each reporting period for changes in the probability assessment.

The chosen method should be applied consistently throughout the contract.

The **expected value method** should be utilized when there are multiple possible outcomes where a contractor would assess the sum of the probability-weighted estimates over a range of possible outcomes. Alternatively, the **most likely amount method** should be utilized when a contractor expects to be entitled to one of only two possible outcomes.

To include variable consideration in the estimated transaction price, a contractor has to evaluate the constraints of that estimate before concluding on the probability. The new accounting standard provides indicators for when a revenue reversal may be probable:

- The amount of the consideration is highly susceptible to factors beyond a contractor's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions and a high risk of obsolescence of the promised good or service.
- The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- A contractor's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- A contractor 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.

The indicators are not meant to be all-inclusive and a contractor may note additional factors that are relevant in their evaluations. In addition, the presence of any one of these indicators does not require a contractor to conclude it is probable that a change in the estimated variable consideration will result in a significant revenue reversal. The new accounting standard permits a contractor to recognize some of the variable consideration when applying the constraints.

A scenario in construction

A contractor enters into a contract with a customer to build student housing on customer-owned land. The contract terms include promised consideration in a fixed amount of \$10 million. The customer has included a contract provision to help ensure the student housing building is placed in service prior to the school year. The contract terms include a \$10,000 per week liquidated damage clause for delivering the certificates of occupancy after the target date and a \$10,000 per week incentive for delivering the certificates of occupancy before the target date. The building is being designed to meet or exceed a certain energy efficiency rating. The contract terms provide a \$200,000 incentive should the building receive the energy efficiency designation; however, the contractor has limited experience on energy efficient projects and has assigned a new project manager to the project.

Conclusion

The contractor concludes that the contract contains two types of variable consideration (liquidated damage/incentive for delivering the certificates of occupancy and the energy efficiency incentive). Based on the contract terms and the specific circumstances, the contractor concludes that the variable consideration for the liquidated damage/incentive should be evaluated based on the expected value method due to the numerous possible outcomes. The contractor performed the following evaluation of the liquidated damage/incentive variable consideration:

Expected value calculation for incentive (liquidated damages):

Target date		Incentive (penalty)	Probability	Projected incentive (liquidated damages)
Weeks early	5	\$50,000	5%	\$2,500
	4	\$40,000	10%	\$4,000
	3	\$30,000	15%	\$4,500
	2	\$20,000	20%	\$4,000
	1	\$10,000	15%	\$1,500
	-	-	10%	-
Weeks late	(1)	\$(10,000)	10%	\$(1,000)
	(2)	\$(20,000)	10%	\$(2,000)
	(3)	\$(30,000)	5%	\$(1,500)
	(4)	\$(40,000)	0%	-
	(5)	\$(50,000)	0%	-
Total		-	100%	\$12,000

The result of the contractor’s expected value calculation for the incentive or liquidated damages indicates that it is probable that the certificates of occupancy will be delivered one week early based on the calculated outcome of \$12,000. As a result, the contractor will include \$10,000 of expected liquidated incentive in the transaction price.

The variable consideration for the energy efficiency incentive should be evaluated based on the most likely amount method since there are only two possible outcomes. The contractor determines the energy efficiency incentive should be excluded from its initial assessment of the variable consideration because of the contractor’s lack of experience on energy efficient projects and because the project manager is new to the company.

Contract consideration at initial assessment:

Base contract price (fixed)	\$10,000,000
Expected value of incentive/ liquidated damages	\$10,000
Most likely outcome for energy efficiency incentive	-
Total consideration at contract inception	\$10,010,000

At each reporting period, the contractor should reassess its estimate of variable consideration and account for any changes in the amount of variable consideration in the period that determination is made as a change in accounting estimate.

Noncash consideration

In many construction arrangements, a customer may choose to procure and provide a contractor certain goods or services that are necessary for the contractor to complete a project. In other circumstances, a contractor may purchase and pay for the required goods and services using a customer’s procurement and purchase functions.

Noncash consideration would include a customer’s contribution of goods or services that are used in the fulfillment of a contract such as customer-furnished materials, equipment or labor if a contractor obtains control of the goods and services. The transaction price should include the effects of any noncash consideration identified in the contract.

The new accounting standard requires a contractor uses the transfer of control guidance to evaluate whether it obtains control of the goods or services, and consider whether it is serving in the capacity of a principal or an agent before concluding on noncash consideration.

When a contractor receives, or expects to receive, noncash consideration the fair value of the noncash consideration is included in the transaction price. The contractor is required to apply the principles of ASC 820, *Fair Value Measurements*, in measuring the fair value of the noncash consideration. If a contractor cannot reasonably estimate the fair value of noncash consideration, it should measure the noncash consideration indirectly by estimating the standalone selling price of the promised goods and services.

The contractor is required to apply the principles of ASC 820, Fair Value Measurements, in measuring the fair value of the noncash consideration

A scenario in construction

A contractor enters into a contract with a lumber yard customer to construct a warehouse. The contract terms allow the customer to provide a significant portion of the materials to be used during construction (i.e., lumber, siding, roofing and other construction materials). The cost of the materials is excluded from the contract price; however, the contractor assumes control of the materials and uses the materials to construct the building.

Conclusion

The contractor determines that it has assumed control of the materials because it is responsible for evaluating the quality of the materials before using them in the construction of the warehouse. The contractor should determine the fair value of the materials (or a reasonable estimate of the fair value based on the standalone selling price of the materials) to determine the amount of noncash consideration, which is likely greater than the cost of the materials to the customer. The value of the consumed materials should be included in contract costs and contract consideration (i.e., the transaction price or contract value) in equal amounts. The effect of including the noncash consideration in the contract totals results in increased revenue and increased cost. The project's profit will not change; however, the inclusion of the noncash consideration in the contract totals may have a timing effect on the amount of profit recognized in a period while the warehouse is under construction and the performance obligation is satisfied over time.

Significant financing component

Construction contractors with contracts exceeding one year should consider whether the pricing of the contract contains an **element of financing**. The new accounting standard **requires** a contractor considers whether the pricing of the contract contains an **element of financing** when, at contract inception, the period between when the contractor transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or more. An element of financing could

be provided to the customer or the customer could provide financing to the contractor as determined by the timing of when consideration is received in comparison to the transfer of the promised goods or services.

To reduce the burden of this requirement, the FASB included a practical expedient in the standard that allows a contractor to ignore a significant financing component when the period between a customer's payment and a contractor's transfer of the goods or services is expected to be one year or less at contract inception. In most circumstances, costs and earnings in excess of billings (underbillings) and billings in excess of costs and earnings (overbillings) on uncompleted contracts are resolved within one year and would not constitute a significant financing component.

For all other longer-term contracts, a significant financing component can be explicitly stated in the contract or implied by the payment terms agreed to by the parties. When a significant financing component has been identified, a contractor would adjust the transaction price by discounting the amount of promised consideration and recognizing interest income (when customer payments are deferred) or interest expense (when customer payments are accelerated) based on prevailing interest rates in the relevant market. A contractor uses the same discount rate that it would use if it were to enter into a separate financing transaction with a customer. The discount rate should reflect the credit characteristics of the borrower regardless of a rate explicitly stated in the contract when it does not correspond with market terms.

The new accounting standard provides for certain situations which would not indicate a financing component:

- A customer paid for goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer.
- A substantial amount of the consideration

promised by a customer is variable, and the amount or timing of that consideration varies based on the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the contractor (i.e., royalties, commissions).

- The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the contractor, and the difference between those amounts is proportional to the reason for the difference (i.e., retainage).

A scenario in construction

A contractor enters into a contract for the construction of a building. The contract terms require customer payment based on scheduled milestones during the three-year term of the project. The performance obligations will be satisfied over time and the milestone payments are scheduled to coincide with the contractor's expected performance. The contract terms provide that retention of 10 percent be withheld by the customer at each milestone payment. The retention payable will be paid to the contractor when the certificates of occupancy are delivered.

Conclusion

The contractor concludes that the contract does not include a significant financing component. The milestone payments coincide with the contractor's performance. The contract requires amounts be retained for reasons other than the provision of finance in accordance with the new accounting standard as the withholding of retention is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

A scenario in construction

A homebuilder enters into a contract with a customer to build a home on the customer's land for \$1.5 million. The project is expected to take two years to complete. The contractor agrees to perform turn-key construction and finance the project through a construction loan acquired from its own lender at a

rate of five percent, which is consistent with prevailing market rates. The terms of the contract require the full amount of consideration be paid when the homebuilder delivers the certificate of occupancy and the homebuilder has determined that it is probable the customer has the ability to obtain the appropriate financing when the consideration becomes due. Had the customer elected to pay the contractor as the performance obligation is satisfied over time, the price would have been \$1.35 million.

Conclusion

The homebuilder is not allowed to apply the practical expedient (i.e., disregard the significant financing component) because the contractor expects, at contract inception, that the period between when the contractor transfers a promised good or service to the customer and when the customer pays for that good or service will exceed one year. The homebuilder determines there is a significant financing component to the contract since the payments made by the customer do not correlate to the performance of the homebuilder and as a result the transaction price is \$1.5 million instead of \$1.35 million. The rate of five percent that the homebuilder is incurring through the construction loan is consistent with the prevailing market interest rates for financing transactions with similar risk after considering the credit characteristics and risk of the customer and is consistent with the variation in the transaction price.

As a result, the homebuilder is required to discount the consideration in the contract. The discounted contract price is used as the expected consideration from the contract when calculating performance satisfied over time and the contractor would accrue interest income to be received upon delivering the certificate of occupancy to the customer.

Significant financing component computation:

Contract price	\$1,500,000
Discount rate	5.00%
Discounted contract price	\$1,357,538

Contract consideration	\$1,357,538
Financing component	\$142,462
Contract price	\$1,500,000

ALLOCATING THE TRANSACTION PRICE

Once the performance obligations have been identified and the transaction price has been determined, the next step is to allocate the transaction price to the performance obligations based on the standalone selling price. The standalone selling price is defined as the price at which a contractor would sell a promised good or service separately to a customer. Once the selling prices have been determined, a contractor will apply the relative values to the total contract consideration and estimate the amount of the transaction price to be recognized as each promise is fulfilled.

The new accounting standard requires additional consideration and documentation of the standalone selling price or when the standalone selling price is not observable, when variable consideration is part of the transaction price, and when there are changes in the transaction price after contract inception.

Standalone selling price

A construction contractor will determine the standalone selling price for each of the performance obligations at the inception of the contract and will not adjust the initial allocation for future changes in any selling prices. A contractor should maximize the use of observable inputs when estimating the selling price. The best use of observable inputs is a contractor's actual selling price for the same good or service. The standard provides three methods for determining the standalone selling price when a

contractor's actual selling price for the same good or service is unavailable, but does not require their use if a more suitable method is available with more observable inputs.

The three suggested alternative methods are:

- **Adjusted market assessment** – The price is based on what a customer would be willing to pay in the market in which the goods or services are being sold, such as a competitor's pricing that is adjusted for the contractor's own costs and margins.
- **Expected cost plus margin** – The price is determined by forecasting the expected costs of satisfying a performance obligation and then adding an appropriate margin for the good or service.
- **Residual** – An estimate of the standalone selling price by reference to the total transaction price less the sum of observable standalone selling prices for other goods or services promised in the contract. The residual method may be used only if the selling price is highly variable because a standalone selling price is not discernible or a price for the good or service has not yet been established.

Depending on the nature of the performance obligations, a contractor may need to use a combination of methods if certain performance obligations have highly variable or uncertain

standalone selling prices. If a standalone selling price is not directly observable for any of the identified performance obligations, a contractor should utilize estimates.

Depending on the nature of the performance obligations, a contractor may need to use a combination of methods...

Once the selling prices have been determined, a contractor will apply the relative values to the total contract consideration and estimate the amount of the transaction price to be recognized as each promise is fulfilled.

A scenario in construction

A contractor enters into a contract with a customer to install an HVAC system for \$1.5 million. The contractor manufactures the ductwork for the system and purchases additional HVAC equipment from other vendors. The contractor does not design or manufacture the purchased HVAC equipment, but it does install the equipment in the customer’s facility. The construction contract includes a one-year preventive maintenance agreement at no additional charge to the customer. The contractor regularly contracts with other customers to provide preventive maintenance services.

The contractor has determined the standalone selling prices for the performance obligations based on its current bid rates and other observable inputs. The standalone selling price for the installation services, manufactured ductwork and purchased HVAC equipment was determined to be \$1.49 million and the standalone selling price for the one-year preventative maintenance service agreement was determined to be \$25,000.

Conclusion

The contractor concludes that the installation services, manufactured ductwork and purchased HVAC equipment should be combined into one performance obligation because the contractor provides significant services of integrating the three items into the customer’s facility (performance obligation #1). The contractor would also conclude that the maintenance agreement is a separate performance obligation since the customer can benefit from this service separately and it is not highly integrated with the installation services (performance obligation #2). The contractor determines that its current bid rates and other observable inputs provide the best representation of the selling price of the various performance obligations. Accordingly, the contractor calculates the ratio of the standalone selling price of each of the performance obligations and allocates the total contract price using the same ratio:

	Standalone selling price	%	Allocation consideration
Performance obligation #1	\$1,490,000	98.3%	\$1,475,248
Performance obligation #2	\$25,000	1.7%	\$24,752
Total	\$1,515,000	100.0%	\$1,500,000

Allocating of variable consideration

When a contract includes variable consideration, a contractor shall allocate the variable consideration it has determined can be recognized. The variable consideration can be allocated to all of the performance obligations based on the relative standalone selling price or only to specific performance obligations depending on its relevance to a specific performance obligation.

Allocations to specific performance obligations must meet both of the following criteria:

- The terms of the variable payment relates specifically to a contractor's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service).
- Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the new accounting standard's objective to allocate in an amount that depicts the amount of consideration which a contractor expects to be entitled in exchange for transferring the promised goods or services to the customer when considering all of the performance obligations and payment terms in the contract.

A scenario in construction

A contractor enters into a contract with a customer to install an elevator for \$4 million. The contract includes an incentive bonus for completion by a specified date totaling \$250,000. In addition, the contract includes a one-year preventive maintenance agreement at no additional charge and up to 200 hours of maintenance services after the one-year preventive maintenance

agreement expires at an agreed upon rate of \$250 per hour. Based on the most likely amount approach, the contractor has determined it is probable of attaining the incentive bonus. Based on the expected value approach, the contractor has determined it is probable that 100 of the 200 hours of maintenance services are probable for a total of \$25,000. The contractor has determined that the standalone selling price of the elevator installation is \$3.95 million and the standalone selling price of the maintenance service agreement is \$100,000.

Conclusion

The contractor concludes that the installation of the elevator and the maintenance services agreement are separate performance obligations. The contractor has concluded that the incentive bonus variable consideration is related specifically to the contractor's efforts to install the elevator prior to the agreed upon completion date (performance obligation #1). In addition, the contractor has concluded that the hourly maintenance variable consideration under the maintenance agreement is related specifically to its efforts to provide maintenance services (performance obligation #2).

Accordingly, the contractor calculates the ratio of the standalone selling price of each of the performance obligations, including the allocation of variable consideration, and allocates the total contract price using the same ratio:

	Standalone selling price	%	Allocated	Variable consideration	Total allocation
Performance obligation #1	\$3,950,000	97.5%	\$3,901,235	\$250,000	\$4,151,235
Performance obligation #2	100,000	2.5%	98,765	25,000	123,765
Total	\$4,050,000	100.0%	\$4,000,000	\$275,000	\$4,275,000

Changes in transaction prices

If the transaction price changes due to an uncertainty, such as a change related to variable consideration, the subsequent change in the transaction price shall be allocated to the performance obligations on the same basis as at contract inception. The transaction price shall NOT be reallocated to reflect changes in standalone selling prices after contract inception.

When contracts include variable consideration, it is possible that changes in the transaction price can arise after a modification, and such changes may or may not be related to performance obligations that existed before the modification. For changes in the transaction price arising after a contract modification, for which the contract modification was not treated as a separate contract, a contractor must apply one of the following approaches:

- A contractor shall allocate the change in transaction price to the performance obligations identified in the contract before the modification if, and to the extent that, the change in transaction price is attributable to an amount of variable consideration promised before the modification and the modification is accounted for as the termination of an existing contract and the creation of a new contract.
- In all other cases for which the modification is not accounted for as a separate contract, a contractor shall allocate the change in transaction price to the performance obligations modified in the contract (that is, the performance obligations that were unsatisfied or partially unsatisfied immediately after the modification).

A scenario in construction

A contractor enters into a single contract with a customer to construct foundations and raise towers for 100 windmills at an agreed upon price of \$100,000 per windmill, totaling \$10 million. The customer controls the land on which the windmills will be constructed. The contract terms include a \$1 million incentive if all windmills are completed within 24 months from the date of the contract. At contract inception, the contractor is not confident it can meet the 24-month completion timeline.

After 12 months, the contractor has delivered 40 windmills and the customer has agreed to a change order to add 50 additional windmills to the original contract at \$95,000 per windmill. The change order increased the incentive timeline to 36 months from the contract inception date for all 150 windmills. The contractor determined that the standalone selling price of the additional 50 windmills is \$100,000 per windmill. At this time, the contractor has determined it is now probable that all windmills will be completed by the 36-month deadline.

Conclusion

The contractor previously concluded that the original contract represented a series of distinct goods or services that should be treated as one performance obligation and that the performance obligation is satisfied over time as the windmills are completed. Because the change order does not represent the standalone selling price of the windmills, the change order should not be accounted for as a separate contract. However, because the additional windmills in the change order are distinct from the windmills already delivered, the change order should result in the termination of the original contract and the creation of a new contract. The impact of the change order and recognition of the incentive award should be accounted for as follows:

Prior to the change order:

	Original contract
Price per windmill	\$100,000
Number of windmills	40
Total consideration recognized	\$4,000,000

Effects of the change order:

	From original contract	Change order	Total
Price per windmill	\$100,000	\$95,000	
Number of windmills	60	50	
Total remaining consideration	\$6,000,000	\$4,750,000	\$10,750,000
Windmills to be completed			110
Price per windmill after change order			\$97,727
	Incentive award		
Incentive award	\$1,000,000		
Number of windmills	150		
Incentive price per windmill	\$6,667		\$6,667
Price per windmill after change order and incentive			\$104,394
			Change in estimate
Incentive price per windmill			\$6,667
Number of windmills delivered prior to the change order			40
Additional revenue recognized at the change order date for performance obligations previously satisfied (change in estimate)			\$266,680

RECOGNIZING REVENUE

In this series, we have identified the contract, identified the performance obligations, determined the transaction price and allocated the transaction price to the various performance obligations. The final step is to recognize revenue as performance obligations are satisfied, by transferring a promised good or service to a customer. This occurs as the customer obtains control of the asset. ASC 606 requires additional consideration and documentation related to the transfer of control, including whether the transfer of control occurs over time or at a point in time.

A contractor must make a determination as to when it believes its customer obtains control...

A construction contractor has satisfied a performance obligation by transferring the promised good or service to a customer. A good or service is transferred when (or as) the customer obtains control of that good or service. Control of a good or service is demonstrated when a customer has the ability to direct its use and obtain substantially all of the remaining benefits associated with the use of the good or service. Control

also means the ability to prevent other entities from directing the use of, and receiving benefit from, a good or service. A contractor must make a determination as to when it believes its customer obtains control. Some possible indicators of control passing to the customer include:

- Using the asset to produce goods or services
- Using the asset to enhance the value of other assets
- Using the asset to settle liabilities or reduce expenses
- Selling or exchanging the asset
- Pledging the asset to secure a loan
- Holding the asset

Control passes to a customer in one of two ways: either at a point in time or over time.

Transfer of control over time

The new standard requires a contractor to determine, at contract inception, whether it will transfer control of a promised good or service over time or at a point in time—regardless of the length of contract or other factors. Depending on the measure of progress a contractor applies, the accounting for a contract that meets the criteria for recognition of revenue over time may be similar to the method a contractor currently applies under existing guidance (i.e., percentage-of-completion). It is presumed that control transfers at a point in time if a contractor is unable to demonstrate that control transfers over time.

The new accounting standard provides that revenue is recognized over time if any of the following criteria are met:

- A customer simultaneously receives and consumes the benefits of the performance obligation as the work is performed.
 - This would apply in many recurring service arrangements for which the simultaneous receipt and consumption by the customer is readily evident; however, in circumstances where simultaneous receipt and consumption is less evident, the standard clarifies that revenue recognition over time is still appropriate when a contractor determines that another contractor would not need to substantially re-perform the work that the contractor has completed to date if the other contractor were to fulfill the remaining performance obligation to the customer.
- A contractor's performance creates or enhances a customer-controlled asset.
 - For purposes of this criterion, the definition of control is the same as previously discussed, in which the customer has the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This criterion would apply in many contractor arrangements where construction occurs on customer-controlled land.
- A contractor's performance does not create an asset with an alternative use to the customer and the contractor has an enforceable right to payment for performance completed to date.
 - An asset created by a contractor has no alternative use if the contractor is either restricted contractually or practically from readily directing the asset for another use (e.g. selling to a different customer). In addition, if the contractor would incur significant economic losses to direct the asset for another use (e.g. a redesign or modification of an asset or an asset sold at a significantly reduced price), the asset is considered to not have an

alternative use.

- A contractor has an enforceable right to payment for performance completed to date if, at any time during the contract, the contractor would be entitled to an amount that at least compensates it for work already performed. This right to payment must be present, even if a customer can terminate the contract for reasons other than a contractor's failure to perform as promised. The amount to which a contractor is entitled must approximate the cost of the goods or services transferred to date plus a reasonable profit margin.

A contractor recognizing revenue over time also needs to determine a measurement of progress towards satisfaction of the performance obligations. Under ASC 606, measuring progress towards completion is performed using one of the following methods:

- **Input method:** Recognize revenue on the basis of a contractor's efforts or inputs to the satisfaction of a performance obligation, such as labor hours, labor dollars, machine hours, costs incurred or material quantities used, relative to the total expected inputs to the satisfaction of that performance obligation.
- **Output method:** Recognize revenue on the basis of direct measurement of the value to the customer of goods or services transferred to date, such as surveys of goods or services transferred to date, appraisals of results achieved, milestones reached or units produced or delivered, relative to the remaining goods or services promised under the contract.

For construction contractors, the majority of performance obligations will be measured over time as control is transferred using the input method. This is consistent with the percentage of completion method under current U.S. GAAP, but the new accounting standard emphasizes that the input method may need to be adjusted when a cost is incurred that does not contribute to a contractor's progress in satisfying the performance obligation. Therefore, costs incurred related to rework or

wasted materials would be excluded from input measurement, as these costs do not represent the transfer of goods or services to a customer. In addition, the cost of uninstalled materials does not represent a contractor's progress towards fulfilling its performance obligations and should therefore not be included in the measurement of progress towards completion calculation. While uninstalled materials are excluded from the measurement of progress, a contractor is permitted to recognize revenue equal to the cost of the uninstalled materials (excluding gross profit) under the new standard.

A scenario in construction

An elevator contractor enters into a contract to remove an existing elevator and replace it with a new elevator in a commercial building for \$4 million. Due to a long lead time on the manufacturing of the new elevator, the contractor orders and incurs cost for the new elevator equal to \$1 million. The new elevator is delivered to the job site six months before it will be installed. The contractor estimates that other costs of \$2 million will be incurred related to the removal of the existing elevator and other labor and materials needed to install the new elevator. Based on the circumstances, the elevator contractor uses the input method based on the cost incurred to measure progress towards completion. At the end of the reporting period, the contractor has incurred other costs of \$1 million and the cost of the new elevator of \$1 million for total costs incurred of \$2 million.

Transaction price	\$4,000,000
Expected costs	
Elevator	\$1,000,000
Other costs	\$2,000,000
Total expected costs	\$3,000,000
Expected gross profit	\$1,000,000

Conclusion

The contractor determines that including the costs to procure the new elevator in the measure of progress would overstate the extent of the contractor's performance since it is uninstalled at the reporting period. As a result, the contractor excludes the \$1 million incurred to procure the new elevator from its measurement of progress. The contractor's measurement of progress includes the other costs incurred of \$1 million against the total expected other costs of \$2 million or 50 percent. The contractor would recognize revenue as follows:

Transaction price	\$4,000,000
Less: Cost of uninstalled elevator	\$(1,000,000)
Net transaction price	\$3,000,000
Measurement of progress	50%
	\$1,500,000
Add: Revenue equal to cost of new elevator	\$1,000,000
Revenue recognized at the reporting period	\$2,500,000
Actual costs of construction:	
Elevator	\$1,000,000
Other costs	\$1,000,000
Total costs of construction incurred	\$2,000,000
Gross profit recognized	\$500,000

As the new elevator is installed, the contractor would reevaluate its progress towards completion and recognize revenue and gross profit based on satisfying the performance obligation.

If a contractor is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time.

Transfer of control at a point in time

The concept of transfer of control at a point in time is very similar to the completed contract method under existing accounting guidance. ASC 606 provides that control has transferred and revenue is recognized at a point in time if any of the following criteria are met:

- A contractor has a present right to payment for the asset
- A customer has legal title to the asset
- A contractor has transferred physical possession of the asset
- A customer has the significant risks and rewards of ownership of the asset
- A customer has accepted the asset

The above list is not all-inclusive and a contractor may determine that specific facts and circumstances enable a conclusion that control has passed to the customer.

The concept of transfer of control at a point in time is very similar to the completed contract method under existing accounting guidance.

A scenario in construction

A homebuilder enters into a contract with a customer to construct and sell a new home for \$500,000. The contract stipulates that the home completion and closing are estimated to take place within nine months from the date of the contract. The homebuilder is also a land developer who will transfer title of the land and

new home when the closing occurs. The homebuilder concludes that the contract to construct and sell the home on the homebuilder's lot represents a single performance obligation where the ultimate output is the completed home.

Conclusion

The homebuilder has evaluated the new accounting standard and determined that the contract does not meet one of the three criteria outlined to recognize revenue over time based on the following:

- The customer is not simultaneously receiving and consuming the benefits of the performance obligation as the work is performed. The customer will not receive the benefits of the performance obligation until closing occurs.
- The homebuilder's performance has not created or enhanced a customer-controlled asset. The asset is controlled by the homebuilder and the customer does not have the ability to direct the use or obtain substantially all of the remaining benefits from the asset.
- The homebuilder's performance has created an asset with an alternative use to the customer and the homebuilder does not have an enforceable right to payment for performance completed to date until the closing occurs. The home under construction could be sold to another customer without incurring significant economic losses by the homebuilder to direct that asset for another use.

Since the contract between the homebuilder and the customer to construct and sell a new home does not meet one of the above criteria, the homebuilder concludes that revenue should be recognized at a point in time. The homebuilder determines that the point in time to recognize revenue is at the closing date when the homebuilder has a present right to payment for the asset, legal title of the asset is transferred to the customer, physical possession of the asset is transferred to the customer, the customer has accepted the significant risks and rewards of ownership of the asset and the customer has accepted the asset.

DISCLOSURES

After navigating the five elements of the revenue recognition process, ASC 606 requires robust disclosures for the users of the financial statements. The new accounting standard requires a contractor to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows. Contractors will need to provide qualitative and quantitative information regarding its contracts with customers, the estimates and judgments the contractor used to measure its revenue, and the nature of any assets recognized related to the costs of obtaining the contracts.

The extent of the disclosures required will vary depending on whether the contractor is a public or private company. Private companies may elect to exclude quantitative information from the required disclosures. These disclosures are required to be presented for each reporting period and include information related to contracts with customers such as the disaggregation of revenue, contract balances, performance obligations, transaction price and significant judgments used in applying the new standard.

Disaggregation of revenue

Disclosures of revenue should be disaggregated according to the nature, amount, timing and uncertainty of revenue and cash flows. Public companies are required to provide qualitative

and quantitative disclosures, whereas nonpublic companies are only required to disclose qualitative information about how economic factors affect the nature, timing and uncertainty of revenues and cash flows.

ASC 606 provides the following examples of potential categories:

- Type of good or service (e.g., general contractor, design services, maintenance services)
- Geographical region (e.g., country or region)
- Market or type of customer (e.g., government, institutional, industrial, infrastructure, commercial, residential, multifamily)
- Type of contract (e.g., fixed-price, guaranteed maximum price, time and materials)
- Contract duration (e.g., short-term and long-term contracts)
- Timing of transfer of goods or services (e.g., at a point in time or over time)

Contract balances

The majority of disclosures related to contract balances are quantitative and as a result a nonpublic company may elect not to disclose this information; however, qualitative information related to contract balances would be required. A construction contractor shall disclose the following information related to its contract balances:

- The opening and closing balances of receivables, contract assets, and contract liabilities from contracts with customers, if not otherwise separately presented or disclosed (required for both public and nonpublic companies)
- Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period
- Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in transaction price)
- How the timing of satisfaction of its performance obligations relates to the typical timing of payment, and the effect that those factors have on the contract asset and the contract liability balances utilizing qualitative information
- Information related to significant changes in contract balances that occurred during the reporting period such as changes due to business combinations, cumulative catch-up adjustments, changes in estimate, contract modifications, impairment of a contract asset, a change in the time frame for a right to consideration to become unconditional, or a change in the time frame for a performance obligation to be satisfied.

The majority of disclosures related to contract balances are quantitative and as a result a nonpublic company may elect not to disclose this information

Performance obligations

A construction contractor is required to disclose all of the following information about its performance obligations:

- When a performance obligation is typically satisfied (e.g., upon shipment, upon delivery, as services are rendered, or upon completion of service) including when performance obligations are satisfied in a bill-and-hold arrangement
- The significant payment terms (e.g., when payment is typically due, whether the contract has a significant financing component, whether the consideration amount is variable, and whether the estimate of variable consideration is typically constrained as defined in the standard)
- The nature of the goods or services that the contractor has promised to transfer, highlighting any performance obligations to arrange for another party to transfer goods or services (e.g., an agent).
- Obligations for returns, refunds, and other similar obligations
- Types of warranties and related obligations

Transaction price allocated remaining performance obligations

A construction contractor is required to disclose all of the following information about its remaining performance obligations:

- The aggregate amount of the transaction price allocated to the performance obligations that are unsatisfied (or partially satisfied) as of the end of the reporting period
- An explanation of when the contractor expects to recognize as revenue the amount disclosed in accordance with paragraph 606-10-50-13(a), which the contractor shall disclose in either of the following ways:
 - On a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations
 - By using qualitative information

A construction contractor that is not a public company may elect not to provide the disclosures about remaining performance obligations. As a practical expedient, all entities may elect not to provide disclosures about remaining performance obligations that have an original expected duration of less than one year and it follows relevant guidance for recognizing revenue over time. A contractor that applies this practical expedient must explain whether or not any variable consideration subject to the constraint is excluded from the information about the transaction price.

Significant judgments used in applying the guidance

A construction contractor shall disclose the judgments and estimates (and any related changes) in applying the guidance in ASC 606 that significantly impact the determination of the amount and timing of revenue from contracts with customers. In particular, a contractor shall explain the judgments used in determining the following:

- With respect to the timing of the satisfaction of performance obligations recognized over time:
 - Methods used to recognize such revenue, input methods or output methods, and the application of either.
 - Information as to how the method utilized faithfully represents the transfer of goods or services.
- With respect to performance obligations satisfied at a point in time, the contractor shall disclose information relevant to its decision as to when the customer obtains control
- With respect to the judgments and estimates related to the transaction price and allocation of the transaction price to performance obligations, including:
 - How the transaction price including variable consideration was determined, including issues related to the time value of money and the measurement of any non-cash consideration
 - Whether the constraint on variable consideration was applied
 - How standalone selling prices were determined and how discounts and variable consideration was applied to specific performance obligations
 - How obligations related to returns, refunds, etc. were determined

A construction contractor that is not a public company may elect to not provide any or all of the following disclosures:

- Paragraph 606-10-50-18(b), which states that a contractor shall disclose, for performance obligations satisfied over time, an explanation of why the methods used to recognize revenue provide a faithful depiction of the transfer of goods or services to a customer.
- Paragraph 606-10-50-19, which states that a contractor shall disclose, for performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of promised goods or services.
- Paragraph 606-10-50-20, which states that a contractor shall disclose the methods, inputs, and assumptions used to determine the transaction price and to allocate the transaction price. However, if a contractor elects not to provide the disclosures in paragraph 606-10-50-20, the contractor shall provide the disclosure in paragraph 606-10-50-20(b), which states that a contractor shall disclose the methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained.

The disclosure requirements under ASC 606 are more extensive than those required under current guidance. The new standard does not provide any examples or illustrations of suggested disclosure formats. This enables contractors to develop acceptable or best practice approaches to the required disclosures.

SPECIAL CONSIDERATIONS

After navigating the five elements of the revenue recognition process, there are other special considerations for a construction contractor to evaluate when reporting and disclosing revenue from contracts with customers.

Construction contractors should be aware of a number of other unique accounting and reporting items that may or may not differ from existing guidance under U.S. GAAP. Special consideration should be given to the accounting and reporting for contract assets and liabilities, contract costs, loss contracts, warranties, uninstalled materials, and mobilization.

Contract assets and liabilities

A contractor will present a contract in its statement of financial position as a contract liability, a contract asset, or a receivable, depending on the relationship between the contractor's performance and the customer's performance at the reporting date.

A contract liability exists if the customer has paid consideration or if payment is due as of the reporting date but the contractor has not yet satisfied the performance obligation.

If the contractor has transferred goods or services as of the reporting date but the customer has not yet paid, the contractor would recognize either a contract asset or a receivable. An unconditional

right to consideration is presented as a receivable. If a contractor's right to consideration is conditioned on something other than the passage of time, the contractor would recognize a contract asset. The transfer from a contract asset to an account receivable balance (when the contractor has a right to payment) may not coincide with the timing of the invoice as is required under current guidance.

Costs in excess of billings and billings in excess of costs recognized on the balance sheet under current GAAP should be similar to the contract asset and contract liability recognized under the new standard.

Contract costs

In conjunction with ASC 606, the FASB amended ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*, to provide guidance on other assets and deferred costs related to contracts with customers. This updated standard provides guidance on accounting for costs a contractor incurs in obtaining and fulfilling a contract to provide goods and services to customers for both contracts obtained and contracts under negotiation.

Incremental costs of obtaining a contract

Under ASC 340-40, the incremental costs of obtaining a contract (i.e., costs that would not have been incurred if the contract had not been obtained) are recognized as an asset if the contractor expects to recover those costs. Recovery can be direct (i.e.,

through reimbursement under the contract) or indirect (i.e., through the margin inherent in the contract). Examples of incremental costs of obtaining a contract may include costs incurred related to contract negotiation, pre-construction, design, engineering, or sales-based commissions.

Costs to fulfill a contract

ASC 340-40 also includes guidance for recognizing costs incurred in fulfilling a contract that are not in the scope of another ASC topic (i.e., inventory, property, plant, equipment). Costs incurred to fulfill a contract include those costs that relate directly to a contract such as materials, labor, subcontracts, allocations of costs that relate directly to the contract, and other costs that are explicitly chargeable to the customer.

Costs to fulfill contracts that are accounted for under ASC 340-40 are divided into two categories: (1) those that give rise to an asset and (2) those that are expensed as incurred. In general, a contractor should recognize an asset related to costs incurred to fulfill a contract if the costs meet all of the following criteria:

- The costs relate directly to a contract or to an anticipated contract that the contractor can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- The costs generate or enhance resources of the contractor that will be used in satisfying (or in continuing to satisfy) performance obligations in the future.
- The costs are expected to be recovered.

Contractors should expense, as incurred, general and administrative costs, costs of wasted material or labor not reflected in the cost of the contract, costs related to past performance, and costs which cannot be identified as associated with a performance obligation.

Amortization and impairment

Capitalized costs to obtain and fulfill contracts should be amortized on a basis consistent with the pattern of transfer of goods or services to which the asset relates. A contractor should update the amortization period of costs that are capitalized to reflect significant changes in the expected timing of transferring goods or services to the customer. Any such change should be accounted for as a change in estimate on a prospective basis. If a contractor determines that the remaining balance of the unamortized costs exceeds the remaining amount of consideration to be received on the contract, when taking into account any remaining costs to be incurred in fulfilling the contract, the contractor should recognize an impairment charge in profit or loss.

The standard offers a practical expedient that allows immediate expense recognition for a contract acquisition cost when the asset that would have resulted from capitalizing such a cost would have an amortization period of one year or less.

Loss contracts

The FASB elected to retain existing guidance in ASC 605-35, with certain amendments, for situations in which a contractor expects to incur a loss, either on a single performance obligation (called an onerous performance obligation) or on an entire contract (called an onerous contract). When current estimates of the amount of consideration that a contractor expects to receive in exchange for transferring promised goods or services to the customer and contract costs indicate a loss, a provision for the entire loss on the performance obligation or the contract shall be made. Provisions for losses shall be made in the period in which they become evident.

Warranties

Warranties are commonly included in contracts to sell goods or services, whether explicitly stated or implied based on a contractor's customary business practices. The new accounting standard identifies two types of warranties.

Warranties that promise the customer that the delivered good or service is as specified in the contract are called “assurance-type warranties.” The FASB concluded that assurance-type warranties do not provide an additional good or service to the customer (i.e., they are not separate performance obligations). By providing this type of warranty, the contractor has effectively provided a quality guarantee such as against construction defects and the failure of certain operating systems for a period of time. Under the new accounting standard, the estimated cost of satisfying these warranties is accrued in accordance with the current guidance in ASC 460-10 on guarantees.

Warranties that provide a service to the customer in addition to assurance that the delivered good or service is as specified in the contract are called “service-type warranties.” If the customer has the option to purchase the warranty separately or if the warranty provides a service to the customer beyond fixing defects that existed as the time the goods or services were transferred to the customer, the contractor is providing a service-type warranty. A service-type warranty represents a distinct service that is a separate performance obligation. Therefore, the contractor should allocate a portion of the transaction price to the warranty based on the estimated standalone selling price of the warranty and recognize revenue allocated to the warranty over the period the warranty service is provided.

Uninstalled materials

ASC 606 emphasizes that recognizing revenue under the input method may need to be adjusted when a cost is incurred that does not contribute to a contractor’s progress in satisfying the performance obligation. Costs incurred related to rework, wasted materials, or uninstalled materials should be excluded from the measurement of progress towards the fulfillment of a contractor’s performance obligations. While uninstalled materials are excluded from the measurement of progress, a contractor is permitted under the new accounting standard—subject to certain criteria—to recognize revenue equal to the cost of the uninstalled materials (excluding gross profit).

A faithful depiction of a contractor’s performance may allow a contractor to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the contractor expects at contract inception that all of the following conditions would be met:

- 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 contractor procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the contractor is acting as a principal in accordance with paragraphs 606-10-55-36 through 55-40).

Based on the above criteria, a contractor should always exclude costs related to wasted materials, rework, or other significant inefficiencies from its measurement of progress. In contrast, when uninstalled materials meet the above criteria, a contractor is allowed to recognize revenue in an amount equal to the cost of the goods and adjust its measure of progress to exclude such costs from the costs incurred and from the transaction price (i.e., from both the numerator and the denominator of its percentage of completion calculation).

Mobilization

Many contractors incur costs to mobilize equipment and labor to and from a job site. Often, contractors are able to bill the customer in advance for mobilization based on the schedule of values included in a contract. Under ASC 606, mobilization costs do not contribute to a contractor’s progress in satisfying a performance obligation and instead these costs are generally considered contract fulfillment costs that are capitalized on the balance sheet and amortized over the expected duration of the contract. This differs from current practice in which mobilization costs have been included in the determination of percentage of completion and as a result the recognition of revenue.

ABOUT BAKER TILLY

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ASC 606 services



What revenue streams should you be focusing on?

You need to understand what your current revenue stream types are and which of those revenue streams pose a risk of high impact.



How will your systems, processes, controls be affected?

Once your revenue streams are identified, our team will work with your stakeholders to begin a detailed inventory and assessment of your contract types, specifically focusing on those contract types identified in the initial assessment as high impact.



What will need to be addressed to comply with ASC 606?

Based on the impact assessment, our professionals will analyze processes, systems, controls and reports for gaps between what is currently in place and what will need to be done to comply.



What is the right path for your company to pursue?

Our multidisciplinary team will work with you to discuss strategy options, determine a plan that is the right fit for your organization and develop the project plan to implement your strategy.



What should you expect in implementing your solution?

Once your strategy is determined and a plan established, our project management and change management professionals will assist you in an implementation plan managed specifically to your organization's culture and its needs.



Have you addressed all controls?

After your solution has been implemented, internal controls must be tested and evaluated for deficiencies. As part of your ongoing management and testing, our professionals can assist with evaluation of your revenue-related internal controls against the COSO 2013 framework.

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