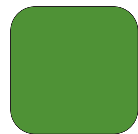

NEW REVENUE RECOGNITION

The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law.

STANDARDS REQUIRE CONTRACTORS TO THINK DIFFERENTLY

ROBERT S. MERCADO AND JAMES W. MILLER

After nearly 1,000 comment letters, with 350 letters from the construction industry alone, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) published a new joint standard on revenue recognition, replacing most of the existing guidance and taking a major step toward converging Accounting Principles Generally Accepted in the United States (U.S. GAAP) and International Financial Reporting Standards (IFRS). The new standard, Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, joined the Codification of U.S. GAAP as Topic 606, effectively replacing Topic 605, with a corresponding IASB reference of IFRS 15, *Revenue from Contracts with Customers*.

The overall goal of the new guidance is depicted in Exhibit 1.

The new requirements will affect different companies in different ways

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JAMES W. MILLER *is an integral member of Marcum's national construction industry group and is located in the New Haven office. He has more than 12 years of experience compiling, reviewing, and analyzing financial statements for construction contractors and other allied companies. Mr. Miller has also been involved in high-profile and sensitive engagements regarding fraud and litigation support and due diligence projects for business acquisitions. A sought-after speaker on construction accounting and auditing matters, Mr. Miller has conducted internal training seminars and has presented on issues and updates regarding the construction industry and construction engagements. Mr. Miller has also applied his knowledge and expertise to the success of two large engagements for universities within Connecticut. Mr. Miller's specialties include troubleshooting problem job performance for construction projects and enhancing profitability. He has considerable experience with construction claims matters and in-depth knowledge of systems analysis. Mr. Miller began his career at Marcum when he joined the firm in 2002.*

EXHIBIT 1 New Guidance Goal

Remove inconsistencies and weaknesses in revenue requirements.
Provide a more robust framework for addressing revenue issues.
Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
Provide more useful information to users of financial statements through improved disclosure requirements.
Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

EXHIBIT 2 Relevant Criteria for Customer Contracts

Commercial substance
Approval by both parties
Identifiable rights regarding assets to be transferred
Identifiable payment terms (even if amount is uncertain)
Probability that you will collect consideration entitled

but will require all contractors to assess the extent of the impact — including extensive new disclosure requirements aimed to enable financial statement users to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Additionally, contractors will have to assess potential changes to systems and processes to collect data. The new standard moves away from the industry- and transaction-specific requirements under U.S. GAAP, which are also used by some IFRS preparers in the absence of specific IFRS guidance.

Depending on whether certain criteria are met, revenue is either recognized over time (in a manner that depicts the contractor's performance) or at a point in time (when control of the goods or services is transferred to the customer). Contractors will apply a five-step model to determine when to recognize revenue, and at what amount. The following list specifies that revenue should be recognized when (or as) a contractor transfers control of goods or services to a customer at the amount to which the contractor expects to be entitled:

1. Identify the contract with a customer.
2. Identify performance obligations.
3. Determine the transaction price.
4. Allocate the transaction price.
5. Recognize revenue.

Step 1: Identify the contract

The new standard defines a contract as an agreement between two or more parties that creates enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral, or implied by an entity's customary business practices. A contract with a customer must meet all of the criteria listed in Exhibit 2.

If a contract meets all of the criteria in Exhibit 2 at contract inception, the contractor does not reassess those criteria unless there is an indication of a significant change in the facts and

circumstances. One of the key differences between the new standard and U.S. GAAP relates to collectability. One of the four revenue recognition criteria under FASB ASC 605 is collectability, which must be considered reasonably assured for revenue to be recognized. Under the new guidance, collectability is a factor when determining whether a valid contract exists.

When a contract does not meet the criteria, the contractor shall continue to assess the contract until such conditions are met; if they are not met, the contractor shall recognize revenue only when either of the following events has occurred:

- the contractor has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the contractor and is nonrefundable, or
- the contract has been terminated, and the consideration received from the customer is nonrefundable.

In the case where the criteria are not met, the consideration received from the customer is recognized as a liability until one of the preceding events occurs or until the contract meets the criteria to be considered a contract with a customer. This liability represents the contractor's obligation to either transfer goods or services in the future or refund the consideration received.

Throughout the life of a contract, other contracts are entered into off the existing contract, or modifications are made to the existing contract through change orders. The new standard clarifies specific definitions as to when to combine or segment contracts and the recognition of revenue when there are contract modifications.

Combination of contracts. The guidance under ASC 606 on combining contracts is similar to the current U.S. GAAP literature with the analysis regarding contracts that were negotiated as a package or have consideration that is linked. There is one main difference, however: Current U.S. GAAP includes indicators for a contractor to consider in evaluating whether two or more contracts *should* be combined, while ASC 606 *requires* that an entity combine contracts that were entered into at or near the same time if they meet any of the following criteria:

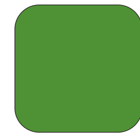
- contracts are negotiated with a single commercial objective;
- amount of consideration in one contract depends on the other contract; or
- goods or services are a single performance obligation.

Contract modifications and claims. A contract modification results when the parties to a contract approve a change in the scope and/or the price of a contract. Several possibilities exist for changes in price or scope. For example, the parties may agree on scope, but not price changes, or they may have a dispute regarding the price or scope. Specific guidance in FASB ASC 605-35 is eliminated with the changes in the new standard. There are distinct differences between the existing guidance and the new standard that may enable contractors to record more change orders than were allowed based on the ASC 605-35. Exhibit 3 shows a few examples of the distinct changes.

Similar to approval of the original contract, approval of a modification could be made orally or in writing, or it could be implied by customary business practice. There are two options for a contractor to account for the contract modification.

1. The contractor accounts for the modification as a separate contract (distinct), which only affects future revenues and is to be adjusted prospectively, if the modification results in both of the following conditions:

- the scope increases to reflect additional promised goods or services that are "distinct" as defined in Step 2 and
- the additional consideration to the seller reflects the added goods or services' stand-alone selling prices and any appropriate adjustments based on the circumstances.



THERE ARE DISTINCT DIFFERENCES BETWEEN THE EXISTING GUIDANCE AND THE NEW STANDARD THAT MAY ENABLE CONTRACTORS TO RECORD MORE CHANGE ORDERS THAN WERE ALLOWED BASED ON THE ASC 605-35.

EXHIBIT 3 Distinct Changes

	Existing Guidance (ASC 605-35)	New Standard (Topic 606)
Unpriced/ Unapproved Change Orders	Record when recovery is probable, considering other factors such as track record of success or failure in pursing change orders, reasonableness of pricing, and evaluation of whether costs relate to work within or outside scope of contract.	May be included in performance obligation (non-distinct) or a separate performance obligation (distinct) before the price of the change order is approved.
Claims	Record only to extend of costs incurred when probable of resulting in additional contract revenue and amount can be reliability estimated (including specific conditions met).	May be included in performance obligation (non-distinct) or a separate performance obligation (distinct) before the price of the change order is approved when there is a change in legally enforceable rights and obligations of the parties.

2. The modification is not accounted for as a separate contract, which results in three potential outcomes. This requires the contractor to evaluate the remaining goods and services to be delivered under the modified contract. The three potential outcomes are as follows:
- If the remaining goods or services are distinct from those delivered before the contract was modified, the contractor treats the modification as a termination of the original contract and the creation of a new contract. As such, the amount of consideration allocated to the remaining separate performance obligations equals the sum of the estimated transaction price (including amounts already received from the customer) not yet recognized as revenue, plus the amount of consideration arising from the modification.
- If the remaining goods or services are not distinct and are part of a single performance obligation that is partially satisfied as of the modification date, the contractor treats the modification as part of the original contract by adjusting the transaction price and remeasuring its progress toward completion of the performance obligation. The revenue recognized to date should be increased or decreased for the effects of the contract modification on a cumulative catch-up basis.
- If the modification represents a combination of the two preceding scenarios, the contractor should use a combination of the two methods.

Under the guidance for construction contracts, contract revenue and costs must be adjusted for approved contract modifications involving scope and price. More detailed guidance is provided for unpriced change orders, which addresses the treatment for costs and revenue. Under the new standard, accounting for contract modifications is heavily focused on the type of modification and is not industry-specific.

Example of contract modifications. A contractor has a single performance obligation to construct a school. During the contract there is a change order to change the electrical work in one of the

EXHIBIT 4 Criteria for Distinct Promised Goods or Services

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. Readily available resources are goods or services that are sold separately (by the contractor or by another entity) or that the customer has already obtained (from the contractor or from other events or transactions).	The promise to transfer a good or service is separable from other promises in the contract. The following factors indicate that a good or service is separable from other goods or services in the contract: • The contractor is not using a single good or service as an input to produce or deliver the combined output specified by the customer. • The good or service does not significantly modify or customize other promised goods or services in the contract. • The good or service is not highly dependent on, or interrelated with, other promised goods or services in the contract. For example, a good or service might not be highly interrelated if a customer can decide not to purchase a particular good or service and that decision does not significantly affect other promised goods or services under the contract.

rooms that is a necessary part of the contractor's service to construct the school. Historically, the owner and the contractor typically agree on the price shortly after the work associated with the change order begins — and historically the change orders have been approved. In this case, the change order is not distinct, it would be added to the contract assuming it was part of the contract since inception, and a cumulative catch-up adjustment would be made.

Step 2: Identifying performance obligations

Once the contract has been identified, the contractor must next identify the performance obligations within that contract. A performance obligation is defined as a promise to deliver a good or provide a service in a contract with a customer. Performance obligations are normally specified in a contract but may also include promises implied by a contractor's customary business practices, published policies, or specific statements that create a valid customer expectation at contract inception. A promise constitutes a performance obligation if the promised good or service is distinct. Examples of promised goods are performing contractually agreed-upon tasks for a customer, including constructing, manufacturing, or developing an asset on behalf of a customer. (See Exhibit 4.)

Goods or services that are not distinct should be combined with other promised goods or services until the contractor identifies a bundle of goods or services that are distinct. For construction contractors, many long-term construction contracts and services contracts will most likely be identified as single performance obligations because they often include a significant integration service.

If a good or service is part of a series of distinct goods or services that are substantially the same and have the same pattern of transfer, the series is on performance obligation if each distinct good or service in the series represents a performance obligation satisfied over time and the same method of progress is used to measure the transfer of each distinct good or service in the series to the customer. Examples of contracts that fit the

EXHIBIT 5 Values and Amounts

Expected Value	Most Likely Amount
• sum of the probability-weighted amounts in a range of possible outcomes • most predictive when the transaction has a large number of possible outcomes • can be based on a limited number of discrete outcomes	• the single most likely amount in a range of possible outcomes • may be appropriate when the transaction will produce only two outcomes

definition of a series of distinct goods are engineering services and project management contracts (construction management), where the contracts would range a year and require maintenance of those contracts continually throughout the year. Rather than having performance obligations for each day, the guidance has allowed for the accounting of these types of contracts to be over the period of time utilizing a measure of input (hours).

Example of identifying performance obligations. A contractor has a contract to design and construct a commercial building. The contractor and other vendors regularly and separately provide design and construction services. Additionally, both the design and construction services are provided together, and the design phase of the contract will require continual alteration during the construction phase. In this case, there would be one performance obligation representing the value of both the design and construction phases of the contract. However, if the contractor determines that the design does not require significant alterations during the construction phase, and the design and construction services are highly interrelated, there may be two performance obligations (one for the value of the design phase and the second for the value of the construction phase).

Step 3: Determining the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled to receive in exchange for transferring goods or services. The transaction price may include fixed amounts, variable amounts, or both.

To determine the transaction price, a contractor should consider the effects of the following:

1. variable consideration;
2. constraining estimates of variable consideration;
3. the existence of a significant financing component;
4. noncash considerations; and
5. consideration payable to the customer.

Variable consideration. The amount of consideration received under a contract might vary due to discounts, rebates, refunds, credits, price concessions, performance bonuses, liquidated damages, penalties, or other similar items. The use of variable considerations will change the view of fixed-price construction contracts. If fixed-price construction contracts include a fixed price plus any incentives (bonuses) for completing early (or penalties for completing late), a variable consideration must be completed. To estimate the variable consideration in a contract, a contractor determines either the expected value or the most likely amount of consideration to be received, depending on which method better predicts the amount to which the entity will be entitled. (See Exhibit 5.)

The expected value method might be appropriate in situations where the variable outcome is a range of outcomes and an entity has experience with a large number of similar contracts that provide a reasonable basis to predict future outcomes. ASC 606 requires an entity to

use the same method to estimate the variable consideration throughout the life of a contract.

Constraining estimates of variable consideration. The objective of the constraint is for a contractor to recognize revenue only to the extent it is probable that a significant reversal in cumulative revenue recognized on the contract will not occur when the uncertainty is resolved. The "probable" term is consistent with the current GAAP guidance, which utilizes a 70 percent likelihood that the future events will occur. To meet the objective, a contractor should make an assessment to determine if it is probable that changes in the contractor's estimate of variable consideration will not result in a significant downward adjustment of the cumulative amount of revenue recognized on the contract. In making this assessment, a contractor should consider all of the facts and circumstances associated with both the likelihood and the magnitude of the reversal if that uncertain event were to occur or fail to occur. The following are indicators that estimates of variable considerations could result in a significant revenue reversal.

- The amount of consideration is highly susceptible to factors outside the contractor's influence, such as market volatility, third-party actions, weather, and obsolescence risk.
- The uncertainty is not expected to be resolved for a long time.
- The contractor's experience with similar contracts is limited.
- There are a large number and wide range of possible consideration amounts in the contract.

There are other variables with the consideration (i.e., awards, incentives, liquidated damages, claims, or unpriced change orders). In this case, the price would be estimated at the expected value (probability weighted) or the most likely

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EXHIBIT 6 Expected Value Approach

Possible Outcomes	Probability	Calculated Amount
$20	40%	$8
$10	40%	$4
$0	20%	$0

amount, with the probability that a significant reversal will not occur. The contractor should update its estimate of variable consideration, including the application of the constraint, at the end of each reporting period to reflect changes in facts and circumstances.

Example of identifying variable considerations and constraints. A contractor has a fixed-price contract for $100, with a $20 bonus if finished a month early. There are only two potential outcomes — the contractor either will either receive the $20 if finished early or will receive nothing. In this instance, because there are only two scenarios, the most likely method will be used. The contractor estimates an 80 percent likelihood that it will receive the performance bonus and a 20 percent likelihood that it will receive none of the performance bonus. Based on these facts and probability analysis, the $20 bonus would be included in the transaction price of the performance obligation, totaling $120.

If the facts were changed, the performance bonus was up to $20 if certain targets were met, and the contractor had determined various probabilities, the expected value approach would be used. An example of this is shown in Exhibit 6.

In the example in Exhibit 6, the contractor would use $12 (sum of the calculated amounts) as the expected value of the performance bonus and would record a transaction price of $112 on the performance obligation.

Once the contractor has evaluated the variable considerations, it must now identify any constraints. The probability that the contractor will receive the performance bonus is 80 percent. The probability is 80 percent (sum of the probabilities of both the $10 and $20 outcomes) that the contractor will receive $12. Both scenarios are greater than the probability threshold of 70 percent that the contractor will receive a performance bonus — therefore a constraint would not be considered necessary against both options.

Significant financing component. In some situations, contractors are paid up-front for contracts. The new standard requires contracts to consider the time value of money and to include financing considerations for any amounts paid ahead of time. Discounting for the time value of money is required only if there is a significant financing component (receivable or payable). Considerations include:

- the expected length of time between delivery of goods and services and receipt of payment and
- whether the amount of payment would differ substantially if cash payment were received in accordance with typical credit terms.

The effects of financing (interest income or interest expense) should be presented separately from revenue from contracts with customers in the statement of comprehensive income. Additionally, retainage is not considered a financing component in the new standard; it is still considered part of the completion of the project.

Noncash considerations. Noncash considerations include customer-furnished materials to facilitate a contractor's fulfillment of the contract. These noncash considerations are measured at fair value or, if not readily identifiable, referenced to the stand-alone selling price in exchange for the consideration.

Consideration payable to a customer. Consideration payable to a customer includes cash amounts that a contrac-

tor pays, or expects to pay, to the customer. It also includes credit or other items that can be applied against the amounts owed. The contractor should account for the consideration payable to a customer as a reduction of the transaction price and therefore of revenue, unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the contractor. If consideration payable to a customer is accounted for as a reduction of the transaction price, the contractor should recognize the reduction of revenue when (or as) either of the following events occurs.

1. The contractor recognizes revenue for the transfer of the related goods or services to the customer.
2. The contractor pays or promises to pay the consideration (even if the payment is conditional on a future event).

Other considerations. The timing of tax payments, the ability to pay dividends in some jurisdictions, and covenant compliance may all be affected. Tax changes caused by adjustments to timing and amounts of revenue, expenses, and capitalized costs may require revised tax planning strategies.

Step 4: Allocation of transaction price

In this phase, an allocation is made, consisting of the amount a company expects to receive in exchange for satisfying each separate performance obligation. Using the school construction example, if there is a tennis court associated with the contract and the stand-alone selling prices for the school and the tennis court are $100 million and $10 million, respectively, 90 percent of the contract consideration would be allocated to the school and 10 percent would be allocated to the tennis court. The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. The new guidance will mostly affect the technology industry, as most of technology contracts include more than one performance obligation for which stand-alone selling prices must be determined. When a stand-alone selling price is not observable, a contractor is required to maximize the use of observable inputs, and/or apply estimation methods consistently in similar circumstances. For construction contractors, the various items within this section, including allocation of discounts, variable considerations, and other selling price considerations, would be attributable to the transaction price of one performance obligation.

After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that alter the amount of consideration. Amounts allocated to a satisfied performance obligation should be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes.

Step 5: Revenue recognition

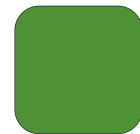
Under U.S. GAAP, the percentage-of-completion method is generally applied when recognizing revenue for long-term contracts. Under the new framework, revenue is recognized only when or as control of the asset is transferred to the customer. The new guidance is focused on the analysis of the contract and the determination of whether a performance obligation is satisfied over time or at a point in time. The contractor should recognize revenue when (or as) the contractor satisfies a performance obligation by transferring a promised good or service to a customer.

Revenue would be recognized when a customer:

- receives benefits as entity performs services;
- creates or enhances an asset that the customer controls; or
- does not create an asset with alternative use and the contractor has right to payment for work completed to date.

Revenue is recognized at a point in time only if control doesn't transfer over time. Factors to consider include:

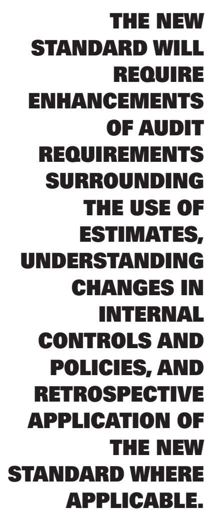
- whether the entity has present right to payment;



THE NEW GUIDANCE IS FOCUSED ON THE ANALYSIS OF THE CONTRACT AND THE DETERMINATION OF WHETHER A PERFORMANCE OBLIGATION IS SATISFIED OVER TIME OR AT A POINT IN TIME.

- whether the customer has accepted the asset;
- whether physical possession of the asset has transferred;
- whether the customer has significant risk and rewards; and
- whether the customer has the legal title to the asset.

Performance obligations will be recognized either using the "gross" or "net" concept. This coincides with the current guidance on recording construction manager contracts in measuring whether the contractor is "at risk" or "not at risk." If the contractor meets the key indicators (i.e., the contractor is not primarily responsible for fulfilling the contract, it does not have inventory risk, it does not have discretion in establishing prices, consideration is in the form of a commission, and the contractor is not exposed to credit risk), that contractor will act as an agent and recognize revenue on the performance obligation utilizing the "net" approach (i.e., purchase obligation will be the total commission fees). If the previously named indicators are not met, the contractor will recognize revenue on the performance obligation utilizing the "gross" method (i.e., purchase obligation will be the total contract value of the project).



THE NEW STANDARD WILL REQUIRE ENHANCEMENTS OF AUDIT REQUIREMENTS SURROUNDING THE USE OF ESTIMATES, UNDERSTANDING CHANGES IN INTERNAL CONTROLS AND POLICIES, AND RETROSPECTIVE APPLICATION OF THE NEW STANDARD WHERE APPLICABLE.

Loss contracts. As with the current guidance, contractors would accrue an anticipated loss once identified. The new standard, however, does not require that losses be accrued on contracts of less than one year's duration. Additionally, the new standard recognizes loss provisions on each performance obligation, not on the contract level. Gains on one performance obligation cannot offset losses on another performance obligation.

So what does this mean?

For some entities, there may be little change in the timing and amount of revenue recognized. However, arriving at this conclusion will require an understanding of the new model and an analysis of its application to particular transactions. Contractors currently using the percentage of completion or proportional performance methods will need to reassess whether to recognize revenue over time or at a point in time. If they recognize it over time, the manner in which progress toward completion is measured may change. Other entities that currently recognize revenue at a point in time may now need to recognize it over time. To apply the new criteria, an entity will need to evaluate the nature of its performance obligations and review its contract terms, considering what is legally enforceable in its jurisdiction.

Disclosures and more required disclosures. There are many new and potentially complex disclosures for contractors, such as more disaggregation of revenue by category, including:

- type of good or service;
- country or region;
- type of customer; and
- type of contract.

Additionally, contractors are required to disclose a reconciliation of the contract balances and costs.

Training. A significant amount of training will be required for everyone from accounting to project managers on changes to documenting contracts. Systems modifications will be needed to capture the additional information required under the new standard, including disclosures, tracking performance obligations, and contract balances. Internal control and company policies will have to be revised and in some cases rewritten.

Additional audit steps. The new standard will require enhancements of audit requirements surrounding the use of estimates, understanding changes in internal controls and policies, and retrospective application of the new standard where applicable. Additional book to tax differences are likely to result from implementing the new revenue recognition standard.

Third-party financial review. Regulatory agencies, such as banking and bonding, will have to rewrite many of the qualifying metrics as defined in many of the covenants in the current agreements. Pre-qualification requirements and bonding capacity measurements will be affected, and policies surrounding the

review of such metrics will have to be reviewed and in most cases rewritten.

Effective date. For public entities, the new standard is effective for annual reporting periods beginning on or after December 15, 2016, including interim periods within that reporting period. Early application is not permitted for public entities. In addition, SEC Staff Accounting Bulletin (SAB) 74 (Topic 11M), *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period*, requires public entities to provide disclosures of new authoritative guidance that has been issued, but this will not be adopted until some future date.

For nonpublic entities, the standard is effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Nonpublic entities may elect to adopt the standard earlier.

FASB allows contractors two options when transitioning to the guidance under the new standard. Contractors may opt for full retrospective application of the new standard, which requires reflecting the cumulative effect of the change in all contracts on the opening retained earnings of the earliest period presented, along with adjusting the financial statements for each prior period presented to reflect the effect of applying the new accounting standard. Retrospective application would be applied to interim periods, as well as annual periods presented. The contractor may elect any of the following practical expedients.

- For completed contracts, a contractor does not need to restate contracts that begin and end within the same annual reporting period.
- For completed contracts that have variable consideration, a contractor may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, a contractor does not need to disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the contractor expects to recognize that amount as revenue.

As an alternative, contractors may apply the amendments to the new standard retrospectively with the cumulative effect of initially applying the amendments recognized at the date of the initial application. When using this method, the contractor should provide additional disclosures in the reporting periods related to the reasons for significant changes. ■