3rd Annual CFMA Southwest Regional Conference | Las Vegas, NV

September 24-26, 2017

Revenue Recognition: The New Standard and a Practical Guide to Implementation

Bret Rutter, Partner, Moss Adams National Office – Construction & Real Estate

Scott Swearingen, Partner, Moss Adams Orange County and Southwest Regional Construction & Real Estate Leader

CFMA 2017 3rd Annual
SOUTHWEST REGIONAL CONFERENCE
SEPT. 24-26, LAS VEGAS, NV

ny revenue recognition training sessio
attended in the last two years?

None	393933
1-3	393935
4-7	393936
Over 7	393938

Start the presentation to activate live content

If you see this message in presentation mode, install the add-in or get help at PollEv.com/app

Total Results: 0

Objective

- Briefly revisit the 5 Step Model and key terminology
- Using examples, apply the concepts of the 5-step process in scenarios specific to the construction industry
    - Change Orders
    - Uninstalled Materials
    - Mobilization
    - Retainage
    - Loss Contracts & Warranties
- New challenges upon implementation for construction companies
- Practical steps to prepare for, assess impact, and implement the new revenue guidance while minimizing disruption

Construction Revenue Recognition (Topic 606)

- **Core Principle:** An entity should recognize revenue to depict the transfer of promised goods or services, to customers in an amount that reflects the consideration to which the entity expects to be entitled, in exchange for those goods or services.

Construction Revenue Recognition – New Terminology

- Performance obligation
- Transfer of "control"
- Contract asset
- Variable consideration
- Constraint
- Distinct
- Transaction price
- Onerous contract

Construction Revenue Recognition – The 5 Step Process

- Identify the contract(s) with a customer
- Identify the performance obligations in this contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognize revenue (or as) the entity satisfied a performance obligation.

…eas are you most concerned with rega… …standard?

Performance obligations	393462
Variable consideration	393465
Timing of recognition	393469
Disclosures	393470

Start the presentation to activate live content

If you see this message in presentation mode, install the add-in or get help at PollEv.com/app

Total Results: 0

Step 1: Identify the Contract

- Contract: an agreement that creates enforceable rights and obligations
- Criteria
  - Approval and commitment of the parties
  - Identification of rights and payment terms
  - Commercial substance
  - Collectability is ***probable*** at inception

Identify the Contract – Evaluating Collectability

- Evaluating Collectability
  - Amount collected vs. the stated contract value
  - Mitigating items that reduce risk of non-collection
    - Right to terminate services for future transfer of goods
    - Enforceability of prompt pay by law
    - Advance payment, for example, through overbilling or mobilization
    - Lien rights
  - Repossession rights should not be considered

Identify Contract – Combining Contracts

Currently, contracts **MAY** be combined if the following:

- The contracts are negotiated as a package in the same economic environment with an overall profit margin objective.
- The contracts constitute in essence an agreement to do a single project.
- The contracts require closely interrelated construction activities.
- The contracts are performed concurrently or in a continuous sequence
- The contracts constitute in substance an agreement with a single customer.

Identify Contract – Combining Contracts

New guidance requires contracts to be combined when entered into at or near the same time with the same customer and if ONE of the following:

- Negotiated as a package with a single commercial objective.
- The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
- The goods or services promised in the contracts are a single performance obligation.

Step 2: Identify Performance Obligations

- Performance obligation: a promise in a contract to transfer a good or service
- When are performance obligations identified?
  - At contract inception
  - As modifications adding additional goods or services occur over the life of the contract

Step 2: Identify Performance Obligations

- Things to consider related to internal controls and processes:
  - What processes and controls are in place to monitor and identify contracts?
  - What processes should be implemented to identify all distinct goods and services within contracts with customers?
  - Does an independent review occur for determinations that are made in regards to separate performance obligations identified within a contract?
  - How does your entity verify there is consistent judgment and application in identifying performance obligations?

Step 3: Determine Transaction Price

- Transaction price: amount of consideration which an entity expects to be entitled in exchange for transferring goods or services
- Complex area = variable consideration and related constraints

Step 3: Determine Transaction Price

- Examples of variable consideration:
  - Performance bonuses/penalties
  - Claims, unapproved/unpriced change orders
  - Liquidated damages
  - Unit pricing
  - Back charges
  - Refunds/rebates/discounts
- Two methods for estimation:
  - Most likely amount
  - Expected value

Example: Most Likely Amount

- $10m fixed price contract to construct an underground tunnel
- $500k performance bonus if completed by January 1, 2018
- Company determined it is 80% likely that it will complete by January 1, 2018

Estimation Method: Most Likely Amount (cont)

- What should be the recorded transaction price?

- Answer: $10.5m
  - Most likely amount approach is most appropriate since there are only two possible outcomes
  - Many factors to consider to arrive at 80% certainty

Example – Expected Value

- $10m fixed price contract to construct an office building
- $5k/day liquidated damages if not complete by January 1, 20xx
- Company determined:

25% probable complete by January 15th

50% probable complete by January 31st
25% probable complete by February 15th

Example – Expected Value (cont)

- What should be the recorded transaction price?

- Answer: $9,846,250
  - $5K*15days =$75,000*25% probability =$18,750
  - $5K*31days=$155,000*50% probability=$77,500
  - $5K*46days=$230,000*25% probability=$57,500
  - Total impact of liquidated damages on transaction price = $153,750 = ($10M-$153,750=$9,846,250)

Step 3: Determine Transaction Price

- Constraint on variable consideration:
  - Only include to the extent that it's ***probable*** a significant revenue reversal won't occur.
- First make estimate, then evaluate possible constraint

Example – Evaluation Against Probability Constraint

Using information from "expected value" estimation methodology example:

- $10m fixed price contract to construct an office building
- $5k/day liquidated damages if not complete by January 1, 20xx
- Remember calculated transaction price - Total impact of liquidated damages on transaction price = $153,750 = ($10M-$153,750=$9,846,250)

Example – Evaluation Against Probability Constraint

- What would the transaction price be if the Company determined that revenue reversal for the associated variable consideration (liquidated damages) was not probable to occur?
- $9,846,250
- What would the transaction price be if the Company determined that the variable consideration (liquidated damages) did not meet the probability constraint?
- $10,000,000

Performance Bonus WIP Visualization

YR 1 Job Name	Estimated Contract Value	Estimated Contract Costs	Estimated Gross Profit	Contract Revenue Earned	Contract Costs Incurred	Gross Profit to Date	Percent Complete	YR 1 Revenue	YR 1 Costs	YR 1 Profit
Wild West	$ 10,500,000	$ 9,000,000	$ 1,500,000	$ 5,250,000	$ 4,500,000	$ 750,000	50%	$ 5,250,000	$ 4,500,000	$ 750,000
Fixed	$ 10,000,000									
Performance Bonus	$ 500,000	< Company determined it met probability constraint to include in transaction price								

YR 2 Job Name	Estimated Contract Value	Estimated Contract Costs	Estimated Gross Profit	Contract Revenue Earned	Contract Costs Incurred	Gross Profit to Date	Percent Complete	YR 2 Revenue	YR 2 Costs	YR 2 Profit
Wild West	$ 10,000,000	$ 9,000,000	$ 1,000,000	$ 10,000,000	$ 9,000,000	$ 1,000,000	100%	$ 4,750,000	$ 4,500,000	$ 250,000
Fixed	$ 10,000,000									
Performance Bonus	$ -	< Company determined it DID NOT meet probability constraint to include in transaction price								

YR 2 Job Name	Estimated Contract Value	Estimated Contract Costs	Estimated Gross Profit	Contract Revenue Earned	Contract Costs Incurred	Gross Profit to Date	Percent Complete	YR 2 Revenue	YR 2 Costs	YR 2 Profit
Wild West	$ 10,500,000	$ 9,000,000	$ 1,500,000	$ 10,500,000	$ 9,000,000	$ 1,500,000	100%	$ 5,250,000	$ 4,500,000	$ 750,000
Fixed	$ 10,000,000									
Performance Bonus	$ 500,000	< Company determined it met probability constraint to include in transaction price								

Liquidated Damage WIP Visualization

YR 1	Estimated	Estimated	Estimated	Contract Revenue	Contract	Gross Profit	Percent	YR 1		
Job Name	Contract Value	Contract Costs	Gross Profit	Earned	Costs Incurred	to Date	Complete	Revenue	Costs	Profit
Miracle in Morgantown	$ 9,846,250	$ 9,000,000	$ 846,250	$ 4,923,125	$ 4,500,000	$ 423,125	50%	$ 4,923,125	$ 4,500,000	$ 423,125
Fixed	$ 10,000,000									
Liquidated Damage	$ (153,750)	< Company determined it met probability constraint to include in transaction price								

YR 2	Estimated	Estimated	Estimated	Contract Revenue	Contract	Gross Profit	Percent	YR 2		
Job Name	Contract Value	Contract Costs	Gross Profit	Earned	Costs Incurred	to Date	Complete	Revenue	Costs	Profit
Miracle in Morgantown	$ 10,000,000	$ 9,000,000	$ 1,000,000	$ 10,000,000	$ 9,000,000	$ 1,000,000	100%	$ 5,076,875	$ 4,500,000	$ 576,875
Fixed	$ 10,000,000									
Liquidated Damage	$ -	< Company determined it DID NOT meet probability constraint to include in transaction price								

YR 2	Estimated	Estimated	Estimated	Contract Revenue	Contract	Gross Profit	Percent	YR 2		
Job Name	Contract Value	Contract Costs	Gross Profit	Earned	Costs Incurred	to Date	Complete	Revenue	Costs	Profit
Miracle in Morgantown	$ 9,846,250	$ 9,000,000	$ 846,250	$ 9,846,250	$ 9,000,000	$ 846,250	100%	$ 4,923,125	$ 4,500,000	$ 423,125
Fixed	$ 10,000,000									
Liquidated Damage	$ (153,750)	< Company determined it met probability constraint to include in transaction price								

Step 3: Internal Control Consideration

- Company will need to maintain contemporaneous documentation over:
  - 1) estimation methodology and assumptions for variable consideration
  - 2) evaluation of constraint (probability significant revenue reversal won't occur)
- Important as assumptions will change as project progresses toward completion
- Consider materiality of variable consideration (as well as potential aggregation risk through Company) in evaluation

Step 3: FS Disclosure

- Significant Judgments and Estimates: Information about the methods, inputs, assumptions used to estimate variable consideration included in transaction price and estimation of the likelihood of significant revenue reversals when the uncertainty associated with the variable consideration is resolved.
- Out-of-Period Revenue Adjustment – Disclose revenue that is being recognized in the current reporting period but were satisfied in a previous period. (due to change in transaction price or change in variable consideration estimate)

Step 4: Allocate the Transaction Price

- Allocate the transaction price to each performance obligation based on a relative ***standalone selling price*** basis at contract inception
- One performance obligation – simple
- Multiple performance obligations – more complex

Step 5: Recognize the Revenue

- Recognize revenue when or as a performance obligation is satisfied by transferring a promised good or services to a customer. An asset is transferred when the customer obtains control of that asset.
- Two methods:
  1) At a point in time Or 2) Over time

Step 5: Recognize the Revenue At a point of time

- If a performance obligation is not satisfied over time, an entity satisfied the performance obligation at a point of time.
- An entity must consider all relevant facts and circumstances to determine whether control has transferred.

Step 5: Recognize the Revenue

- Revenue is recognized over time if:
  - The customer simultaneously receives and consumes the benefits as the entity performs; or
  - The entity's performance creates or enhances an asset that the customer controls; or
  - The entity's performance doesn't create an asset with an alternative use to the entity and enforceable right to payment exists.

Step 5: Recognize the Revenue Shortcoming of Input Methods

- No direct relationship between inputs and the transfer of control of good or services
    - 1) costs incurred attributable to significant inefficiencies – excluded
    - 2) costs incurred not proportionate to progress in satisfying the P.O. (e.g. uninstalled materials)

Step 5: Recognize the Revenue Uninstalled Materials

In September 20X8, an entity contracts with a customer to refurbish a 2-story building and install new HVAC system for total consideration of $4 million. The promised refurbished service, including the installation of HVAC, is a single performance obligation satisfied over time. A summary of the transaction price and expected costs is as follows:

Step 5: Recognize the Revenue Uninstalled Materials

INPUT METHOD - Uninstalled Materials			
Transaction price		**$4,000,000**	
Expected costs:			
HVAC system		**1,500,000**	
Labor and overhead		**2,000,000**	
Total expected costs		**3,500,000**	
at 12/31/20X8			
Labor & OH incurred to date	**$**	**500,000**	
Performance completion		**25%**	**= $500,000/$2,000,000**
Revenue earned			
Revenue recognized	**$**	**625,000**	**= 25% x ($4,000,000 - $1,500,000)**
Cost of HVAC		**1,500,000**	
	$	**2,125,000**	
Total costs		**2,000,000**	**= $500,000 + $1,500,000**
Profit	**$**	**125,000**	

Step 5: Recognize the Revenue Loss Contracts

- No changes to ASC 605-35 – Expected loss to be accrued
  - Loss provision to be determined at a contract level
  - Alternatively, an accounting policy election can be made to determine loss provision at the performance obligation level

Step 5: Recognize the Revenue Capitalization of Costs

- Incremental Costs to Obtain a Contract
  - An entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover the costs.

Step 5: Recognize the Revenue Capitalization of Costs

A contractor wins a competitive bid to provide construction services to a new customer. The entity incurred the following costs to obtain the contract:

External legal fees for contract review	*	$	15,000	Period cost
Travel costs to deliver proposal	*		15,000	Period cost
Commission to sales employee			10,000	Capitalized
		$	40,000	

* Not qualified to be capitalized as they would have been incurred regardless of whether the contract was obtained.

Step 5: Recognize the Revenue - Retainage

- Not considered a financing component when determining the transaction price
  - Retainage payment terms reflect protection for the customer to protect from failure to perform, not implicit financing
- May not be a "receivable"
  - A receivable is a right to consideration that is unconditional; only the passage of time is required to collect

Step 5: Recognize the Revenue – Internal Control Consideration

- What controls are in place to determine whether revenue related to a performance obligation is recognized at a point in time or over time?
- What mechanism does the entity have in place to track the revenue recognized for performance obligations in contracts?
- How does the entity periodically review that performance obligations are being satisfied and that the appropriate amount of related revenue is recognized and recorded?
- Are there processes and controls in place to identify and capitalize contract costs that should be considered incremental?
- Does the entity have controls in place to periodically review contract costs and to test capitalized amounts for recoverability and impairment?

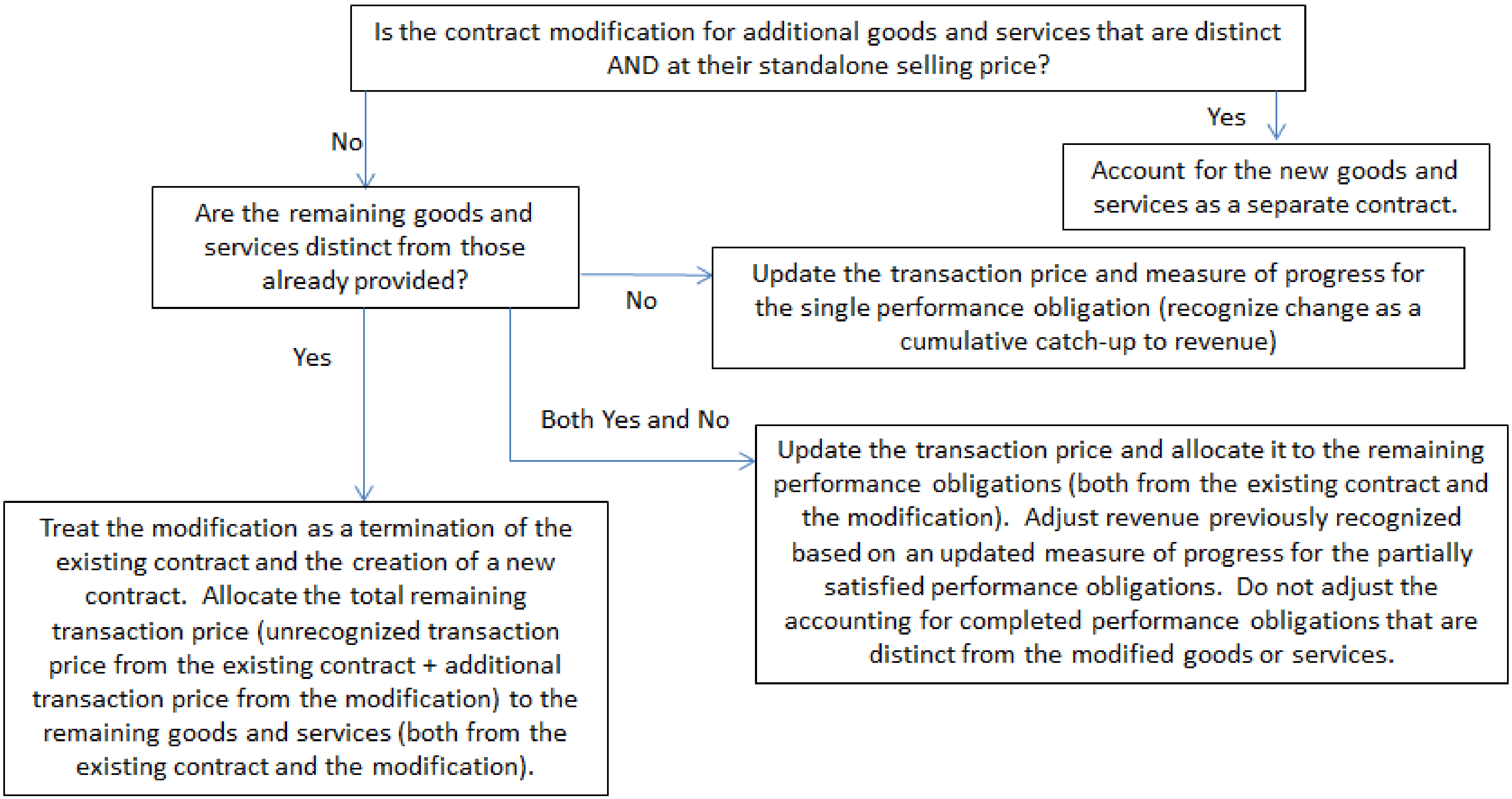
Step 5: Recognize the Revenue - Internal Control Consideration

- How will the entity ensure consistency in judgments in estimating progress towards completion of a performance obligation?
- What controls are in place to monitor and assess costs incurred in fulfilling a contract as an asset or an expense?
- What mechanism does the entity have in place to track the uninstalled materials located at job sites?

Contract Modification – Accounting for Change Orders

- Current Standards –
  - Change orders are accounted for as a modification of the original contract. Current standards provide 3 different methods to time measurement and recognition.
  - Change orders with agreement on scope but no agreement on price are accounted for under claim recognition guidance.
- New standard guidance is "Contract Modification"
  - Determination of whether the change order is:
    - A) A new, separate contract, or
    - B) Terminates the existing and replaced by a new contract, or
    - C) Continuation of the existing contract.
  - May require evaluation under new "Variable Consideration" concept if terms (price or scope) is not agreed upon.

Contract Modification – Accounting for Change Orders



Contract Modification – Accounting for Change Orders Example

Facts:

- Contract to construct a building on customer-owned land.
  - Contract states customer will provide contractor with access to the land within 30 days of contract inception.
  - Contractor was not allowed access until 120 days after inception.
  - Contract specifically identifies any delay in the access to the land as an event that entitles the contractor to compensation that is equal to the actual costs incurred as a result of the delay.
  - Contractor demonstrates that direct costs were incurred due to delay and prepares a claim.
  - Customer initially disagrees with the claim.

Contract Modification – Accounting for Change Orders Example

Results:

- Contractor assesses the legal basis of the claim
  - Upon assessment, the contractor determines that is has enforceable rights based on the underlying contract terms.
  - Therefore contractor accounts for the claim as a contract modification :
    - The modification does not result an any additional goods or services to be provided.
    - The remaining goods and services after the modification are not distinct and they do not form part of a single performance obligation.
    - Consequently, the entity accounts for the modification by updating the transaction price and the measure of progress towards complete satisfaction of the performance obligation.
      - The contractor must consider the constraint on estimates of variable consideration when estimating the transaction price.

Effective Dates

- Public Entities
  - Periods beginning after 12/15/17
- Nonpublic Entities
  - Periods beginning on or after 12/15/18
  - Early adoption permitted up to the public entity effective date

Transition

- Two methods are allows for transition (nonpublic):
  - Full Retrospective
    - All periods presented would report under new standard
      - New GAAP applied to 2019 and applied to 2018 if presenting comparatively
    - Cumulative catch-up adjustment (beginning retained earnings) as of the first day presented, single year or comparative.
    - Disclose prior-period information that has been adjusted
  - Modified Retrospective
    - Only initial period of adoption reported under new standard, other periods presented under existing GAAP
    - Cumulative effect adjustment (beginning retained earnings) 1/1/2019
    - Disclose effects of adoption on each FS line item

e Blackjack analogy, where is your Co
implementation of the Revenue Recogni
dard?

Blackjack	394172
Holding 16 and uneasy	394545
Splitting 2s and praying	394546
Doubling Down king for help)	394549

Start the presentation to activate live content

If you see this message in presentation mode, install the add-in or get help at PollEv.com/app

Total Results: 0

Implementation Considerations

- The new standard significantly increases the amount of information companies are required to disclose about their revenue activities and related transactions.
    - This will require new processes, procedures, and controls to gather data and identify the applicable disclosures that are required based on relevance and materiality.

Implementation Considerations

- How will this standard impact recognition & reporting?
  - Management will need a process to evaluate and document as needed each significant contract modification.
  - Any separate contract resulting from a contract modification will require considering whether it contains more than one performance obligation that is distinct.
  - Any separate contract will require separate accounting tracking or allocations of costs, billings, and revenue recognition.
  - The separate contract will be reported separate from the original contract on the contract schedule.

Implementation Considerations

- How will this standard impact recognition & reporting (cont.)?
  - Sureties will want to see the combined effect of all contracts which are bonded under a single surety bond. Also the impact of the combining guidance goes against the surety's separate risk on single projects.
  - Software may need revised as to facilitate the changes to revenue recognition such as combining of jobs for certain reports that are treated separately for revenue recognition.
  - It is likely that tax reporting will not qualify for separate reporting and book/tax timing differences can arise.

Implementation Considerations

- The impact of adoption will likely be complex and far-reaching involving many different function within an organization.
  - Information systems may require adjustment.
  - Standard contracts and other sales agreements should be evaluated in light of the changes.
  - Sales incentives/commissions should be considered.
  - Internal control processes may need updating.
  - Executive compensation arrangements
  - Debt covenants
  - Tax Implications
  - Software enhancements to support
  - Expect to incur additional costs

Implementation Considerations – Next Steps

- Assemble the Team - Key internal and external stakeholders & meet regularly
- Develop an implementation plan with your "Steering Committee", including roles, high level assessments of tasks, and critical path timelines
- Deal with Key Questions
  - Impact on tax planning
  - Internal controls
  - Software
  - Identification of contract and performance obligations
  - Measurement of variable consideration & allocate price

Implementation Considerations – Next Steps

- Deal with Key Questions
  - Pre-Contract costs
  - Uninstalled materials
  - Warranties
  - Disclosures
  - Transition method – full or modified retrospective
  - Set your date
- Monitor progress and key milestones

Questions?

Bret Rutter, Partner, Moss Adams National Office – Construction & Real Estate

Bret.rutter@mossadams.com or 206 302-6866

Scott Swearingen, Partner, Moss Adams Orange County and Southwest Regional Construction & Real Estate Leader

Scott.Swearingen@mossadams.com or 949 221-4025