Williams Overman Pierce, LLP
Certified Public Accountants and Consultants

CONTRACTORS, DON'T WAIT TO ACT ON REVENUE RECOGNITION

By Jody Hillenbrand and Luis Torres

Jan. 1, 2019, is quickly approaching. For most privately held construction companies, this is the implementation deadline for the new revenue recognition standard, Accounting Standards Codification (ASC) 606*, Revenue from Contracts with Customers.* The time to act is now, especially for contractors with projects lasting over 12 months. A contract that starts now, but extends into 2019, will be subject to the new standard.

In discussing the implementation with many people in the industry, the responses range from "Can't you just tell me what to do?" to "I just need to write a memo; we're not changing anything." Why is there such disparity in responses regarding the implementation of an accounting standard? In the U.S., there's an expectation of specific, rules-based authoritative guidance from the Financial Accounting Standards Board (FASB). As we move toward convergence with international standards, the change from rules-based to principals-based guidance means there won't always be black-and-white answers. Under ASC 606, there's the potential that two companies could account for similar contracts differently—but both appropriately. This could cause significant issues with sureties and bankers, who have grown accustomed to percentage-of-completion accounting under the previous guidance, which has been consistent for 35 years.

WHAT DO CONTRACTORS NEED TO DO NOW TO MAKE SURE THEY ARE READY TO IMPLEMENT THE STANDARD?

1. **Assemble your team.** While revenue recognition is inherently an accounting topic, this evaluation will need to involve owners, accounting personnel, project managers and anyone else familiar with the company's contracts.

2. **Identify whether a contract exists.** Under ASC 606, a key step in the evaluation process is to identify the contract. Fortunately, the construction environment tends to make the identification of when a contract exists fairly clear.

3. **Take an inventory of contracts.** Once the team has been identified, one of its first tasks is taking an inventory of contracts and segregating them by type. There are several issues that impact a contractor's determination of when it has a contract. For master service agreements, job order contracts and other similar contracts, careful evaluation will need to be made to ensure all five criteria to account for a contract under ASC 606 are met. This is why the inventory of contracts is such an important process. It is the foundation of the evaluation for accounting under ASC 606.

4. **Evaluate contracts.** Once the inventory is complete, a representative sample of contracts by type should be evaluated regarding implementation issues. Consideration should be made for multiple performance obligations (especially for master service agreements), uninstalled materials, termination clauses, warranties, liens, change orders and any other nuances that impact costs, collection and delivery of service.

5. **Evaluate impact on internal controls.** In addition to accounting implementation issues, the impact on systems, internal controls over financial reporting and operations should also be evaluated.

6. **Engage software providers in the conversation.** Software that was sufficient under the previous standard may not provide adequate information under the new standard. Contact with software providers early in the planning process is important to clarify system controls versus manual controls.

7. **Consider the potential tax implications now.** In addition to the impact on book reporting and internal controls, there are many potentially significant tax implications that companies should consider up front. Because the new standard not only impacts *how* revenue is recognized, but also potentially *when* it is recognized, there are significant changes to book rules that may

require your organization to put in place new data collection and retention policies to substantiate tax changes.

Possible tax implications could include:

- Tax accounting method changes
- Book-tax differences
- Cash taxes
- Accounting for income taxes (ASC 740): Deferred taxes, current/non-current taxes payable—at adoption/prospective
- Federal, state, indirect and foreign taxes
- Transfer pricing

WHAT ARE THE CORE DIFFERENCES BETWEEN THE NEW REVENUE RECOGNITION STANDARD AND THE OLD?

Revenue will be recognized based on transfer of control:

Under ASC 606, we move from a model where revenue was recognized based on transfer of risks and rewards to a model where revenue will be recognized based on transfer of control. While this may result in many construction contracts being recognized in a pattern similar to percentage-of-completion, there are certain differentiating factors to consider. Revenue may now be recognized either over time or at a point in time. First, a contractor must determine if revenue for a contract must be recognized over time. To qualify, one of the following criteria must be met:

1. The customer simultaneously receives and consumes all of the benefits,
2. The entity's work creates or enhances an asset controlled by the customer, or
3. The entity's performance does not create an asset with alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If none of these criteria are met, revenue will be recognized at a point in time. In some cases where the first two criteria are not met and it was believed that the third criteria would be met, upon further review of the contract terms it is not clear that the contractor has an enforceable right to payment. This has been the case with certain government contracts. If the contractor and legal counsel can't support that there is an enforceable right, revenue for these contracts will have to be recognized at a point in time, which will be a significant change. Careful review of contracts and their terms is necessary and it's best to do this well in advance of date of adoption.

Changes related to measuring performance:

Once a contractor concludes that recognition over time is appropriate, the method of measuring performance should be determined. Both output methods (surveys, appraisals of results, milestones, etc.) and input methods (labor hours, costs incurred, time, etc.) can be used to measure performance. Currently, under percentage-of-completion, the "cost-to-cost" method of measuring completion on a project is the most commonly used, which is similar to one of the input methods permitted under ASC 606. However, costs such as pre-contract costs, uninstalled materials and cost overruns from inefficiencies or re-work may be treated differently. These changes can shift when revenue is recognized during the project.

New guidance on the treatment of precontract costs:

Under current GAAP, contractors can capitalize precontract costs as long as recovery is probable. Once the contract is awarded, the costs are allocated to the project and are included in costs in evaluating percentage-of-completion. Under ASC 606, these same costs, along with mobilization costs, may be required to be capitalized and then amortized over the life of the contract as the performance obligation is satisfied. This will create another level of monthly adjustment to contract costs and a deferral of the incremental profit recognition.

Changes to accounting for uninstalled materials:

Currently, there is diversity in practice for how to account for uninstalled materials, which for many contracts can be significant and can greatly affect when revenue is recognized when a cost-to-cost method is applied. The new standard asserts that there may not be a direct relationship between these costs and the satisfaction of the contractor's performance obligation. As a result, revenue may be recognized only up to the cost on uninstalled materials, but the incremental profit related to those costs will be deferred until the equipment is installed and the applicable costs will be excluded from the cost-to-cost calculation. This will result in timing differences in profit recognition.

In addition, for contractors recording percentage-of-completion adjustments monthly under cost-to-cost, there will need to be a two-part evaluation on revenue recognition for installed and uninstalled costs. Judgment will be required to determine how to treat the related costs in the cost-to-cost model after installation (e.g., should the costs be added back or excluded for the full length of the contract?) For many contractors, tracking this data will be a big change and conversations with software providers should be happening soon.

Increased disclosure requirements:

The new standard will require the gathering of information in new and different ways, which could be time-intensive to implement initially. Remember that even if the timing of revenue recognition is not materially changed from current reporting, the new standard requires much more robust disclosures, even for private companies. Many contractors will have to change their processes and controls over contracts and job costs. Accounting departments will need greater understanding of the underlying contracts, including when the sales teams make modifications to the standard contract clauses.

With these complex considerations in mind, there is no time to waste. Contractors that haven't started the process of implementing revenue recognition yet are already behind.

For more information, contact one of our Construction Industry Group partners:

George S. Lambert, Jr., CPA, CCIFP

glambert@wopcpa.com

919-645-6932

MaryEllen Prance, CPA

mprance@wopcpa.com

919-645-6940

Gwen Vass, CPA, CFE

gvass@wopcpa.com

919-645-6955