# The Issue

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# Contractors and Developers Beware:

## *New revenue recognition rules requiring your judgment coming*

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For most contractors and many developers, revenue is the biggest line item on their financial statements. They generally understand that they must recognize revenue (i.e., book income from their contracts) as they earn it. Soon, all developers and contractors will be affected by the new revenue recognition rules found in Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, issued by the Financial Accounting Standards Board (FASB). [i]

Long-standing industry-specific guidelines will be eliminated, including some that have been a part of GAAP for decades such as SOP 81-1, Accounting for Performance of Construction Type Contracts, contract accounting (ASC 605-35) and real estate sales (ASC 360-20).

The new accounting standards add a new dimension to finance – JUDGMENT; and there is little guidance on how to apply it. This discussion is a brief survey of the new rules as they apply to the construction and real estate development industries.

There is now significant judgment required in obtaining contract information, determining transaction price, calculating probable estimates of variable consideration, and recognizing revenue at blended prices due to modifications.
An understanding of these principles will save time when change is required.[ii]

**The basic Principle**
The ASU contains an overarching principle that a company should recognize revenue when it transfers goods or services to a customer. The amount of revenue recognized should represent the consideration to which it expects to be entitled.

To apply these principles, the ASU outlines a five-step process:

1. Identify the contract with a customer
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations in the contract
5. Recognize revenue when (or as) the entity satisfies a performance obligation

Contractors and developers won't always perform these steps sequentially. For example, let's say a developer enters into a series of contracts with a customer to entitle and construct a building and parking garage. The parties separately agree for Developer to install surveillance equipment and provide monitoring services on an annual basis, once the facilities are constructed.

Before identifying all the separate performance obligations (Step 2) in the various arrangements, the developer may first want to simultaneously perform Steps 1 and 3 to identify whether the various contracts should be combined and, if so, determine the transaction price of the total accounting unit.

Overall, it's really a change in mind-set. Much of today's GAAP is built around the notion that revenues are recognized when substantially all the risk of loss from the sale has passed to the customer. The trigger for revenue recognition under the ASU is based on the transfer of control over a good or service to the customer. As a result, the new model could lead to very different revenue recognition patterns and timing.

In some circumstances the new five-step process may result in the same accounting outcome as current GAAP, but the logic and reasoning for reaching those conclusions may be different. I will develop this point in a future blog.

**1. <u>Identify that a contract exists with a customer</u>**

A construction contract is in the scope of the ASU if all of the following conditions are met:

- The parties have approved the contract and are committed to performing their respective obligations
- Each party's rights regarding the goods or services to be transferred can be identified
- The payment terms are identifiable, and it is probable the contractor will collect the consideration
- The arrangement has commercial substance

If a contract fails to meet all of these criteria, the ASU prescribes a very draconian accounting outcome - no revenue is recognized until one of the following occur:

- The contractor's performance is complete and substantially all of the consideration in the arrangement has been collected and is nonrefundable
- The contract is terminated and the consideration received from the customer is nonrefundable
- The four conditions noted previously are subsequently met

There is a potential slippery slope here for developers. Note the requirement that it must be probable that the contractor will collect the consideration to which it is entitled. This is a judgement call.

Let's say a developer entitles and constructs a retail center in a sparsely populated but growing area and sells it to a retail operator. The customer enters into a long term non-recourse financing arrangement with the developer to pay the developer over several years. The customer intends to make payments from rents.

There are few potential customers in the region to support the retail operation contemplated by the customer. The developer can look only to the property for payment in the event of the customer's default. In this scenario, the customer's intention and ability to pay may be in doubt. Under previously existing GAAP, the developer would record the sale at the time of the transfer of possession and control to the customer. But under ASU, the developer may conclude that it is not probable that he will get paid the full consideration. Therefore, he cannot record the sale until substantially all of the consideration is received from the customer, or the probability of getting paid substantially increases.

**2. <u>Identify performance obligations</u>**

The performance obligations can be tricky. In a construction contract, depending on the scope of work and how it is defined, the contractor may be able to segment the contract into separate profit centers if certain conditions are met. For example, a contractor may submit a bundled proposal to deliver a retail center, an office building, and a parking garage in three phases, all on a single parcel of land. Depending on facts and circumstances, the contractor may be able to account for the retail center, building and garage portions of the contract separately, with different margins assigned to each contract segment. So, there would be distinctly separate performance obligations for each of the three parts of the contract.

On the other hand, assume a contractor agrees to rebuild a dilapidated warehouse for a customer. The construction process will involve a number of steps, including demolishing the existing structure, pouring a new foundation, framing, installing plumbing and electrical, insulating the walls, installing drywall, and performing finish work. Each of these activities is capable of being distinct. For instance, the customer can benefit from the demolition even if the contractor performs nothing else. Similarly, the customer would obtain value from contractor's framing services or its drywall installation.

However, within the context of the entire contract, the various goods and services aren't distinct. Each one represents an input to produce a combined output specified by the customer, a rebuilt warehouse.

Because the various aspects of the contract are interrelated, the contractor wouldn't have distinct performance obligations for each step of construction process. Therefore, the contractor would reasonably conclude that there's just one performance obligation in the arrangement, delivery of a rebuilt warehouse, upon which the revenue from the contract would be recognized, seemingly requiring deferral of revenue to completion of the project. However, this is not necessarily the case.

Under the proper conditions, described in step 5, revenue may be recognized as the project progresses.

**3. <u>Determine the total transaction price</u>**

You might think that in a fixed fee contract it is easy to determine the total transaction price. But this step can be challenging and require some judgment. This is because the company must consider potential discounts, concessions, back charges, liquidated damages, performance bonuses, and other forms of variable consideration when calculating the transaction price.

For example, a construction contract could provide that if the project is delayed, the contractor will pay liquidated damages of say $1,000 for every day delayed. Or, if a project is completed prior to year-end, the contractor will receive a performance bonus of $1 million.

Variable consideration should be calculated using either a best estimate or expected value approach, whichever method better predicts the amount of consideration to which an entity will ultimately be entitled.

For example, assume a developer agrees to refurbish an office building. The fixed price is $10 million. If the building receives a LEED Gold Certification, developer will receive a $500,000 performance bonus. The developer believes it's 60 percent likely that it will receive the certification.

Since the variable performance bonus has just two possible outcomes, the developer will use a best-estimate approach to measure the variable consideration. This means the developer will include the $500,000 performance bonus in its calculation of the transaction price, since his best estimate is that the bonus will be earned. Thus, the total transaction price for this contract would be $10.5 million.

Now let's assume the developer enters into a second contract to rehab a different building. The fixed price is $25 million. However, if the work isn't completed by January 1, 2017, the developer will pay $10,000 per day in liquidated damages, capped at a maximum of $1 million.

The table below shows the estimated probability that the work will be completed at various points in time:

| **Probability** | | **Total Fee** | **Weighted** |
|---|---|---|---|
| On or before January 1, 2017 | 80% | $25,000,000 | $20,000,000 |
| January 15, 2017 | 6% | $24,850,000 | $1,491,000 |
| January 31, 2017 | 7% | $24,690,000 | $1,728,300 |
| March 1, 2017 | 4% | $24,400,000 | $976,000 |
| March 31, 2017 | 2% | $24,100,000 | $482,000 |
| On or after April 10, 2017 | 1% | $24,000,000 | $240,000 |
| | **100%** | | **$24,917,300** |

Because there are a number of possible outcomes, the developer determines that an expected-value approach would better predict the amount of consideration to which it will be entitled. Accordingly, the developer measures the transaction price at the expected value of $24,917,300.

No matter which method a company uses to measure variable consideration, the transaction price should be reevaluated and updated as necessary each reporting period over the course of the contract, as better estimates become available.

**4. <u>Allocate the Transaction Price to the Performance Obligations</u>**

Because a contractor delivers a custom finished project that is always different, and is comprised of several distinct individual performance obligations that are also different from project to project, the contractor will have to estimate the stand-alone selling price for each individual performance obligation in its contract. The only way to do this for a unique product or service is by a bottom-up approach where the contractor estimates its costs to construct the project then adds a reasonable margin for its production and selling efforts. This is also true for a developer who agrees to rebuild a dilapidated warehouse for a customer. Even though the individual performance obligations - demolition, new foundation, framing, installing plumbing and electrical, insulating the walls, installing drywall, and performing finish work - are not distinct within the context of the contract because they're interrelated, for purposes of allocating the transaction price, they are still separate performance obligations.

However, the fact that the arrangement contains just one distinct performance obligation doesn't mean that all revenue will be deferred until the new warehouse is completed.

**5. <u>Recognize revenue as the entity satisfies a performance obligation</u>**

Revenue is recognized each time there is a transfer of a good or service to the customer and the customer obtains control over the delivered item. In some situations, control over a good or service isn't transferred at a point in time but rather over time. This would occur when the company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced. For example, a developer performs refurbishments on a manufacturing plant owned by a customer. As the work is performed, the customer's asset is enhanced.

The developer may be able to recognize revenue over time as the renovation work is performed, instead of waiting until the entire job is complete.

When revenues are recognized over time, the ASU allows companies to measure performance using either one of two input measures, costs or labor hours incurred, or milestones, units delivered or put in place. However, the contractor doesn't necessarily have free choice to select a measure of progress. Instead the performance measure should be determined based on the method that best reflects the pattern in which the entity satisfies its performance obligations, considering the nature of the goods and services being provided to the customer.

Units-of-delivery or production method may only be appropriate if, at the end of the reporting period, the value of any work in progress or units produced but not yet delivered to the customer is immaterial. This is because, if customers are gaining control of an asset over time, revenues should be recognized on a corresponding basis. Waiting to recognize revenues until a unit is produced or delivered may fail to properly match the timing of revenue recognition when control over the goods are transferred to the customer. This outcome could be a significant change in practice for many contractors that currently use the units-of-production or units-of-delivery method to recognize revenue from production contracts. On the other hand, the cost-to-cost method requires little judgment since the measure is a simple ratio of the actual costs incurred to the total estimated costs to construct the project.

**<u>Conclusion</u>**

There are significant new judgment calls in how the contract affects the ability to recognize revenue. Decisions that were previously straight forward now offer flexibility that requires peering down the road to identify possible adverse consequences. Whether a contractor uses milestones or work in place as opposed to costs incurred must be determined by which method more accurately reflects the pattern of performance. Generally speaking, there will be few differences in employing a cost-to-cost or similar input measure of progress under the ASU versus how this type of method is applied under current GAAP; but your CFO should review your existing revenue recognition policies before a judgement call results in covenant violations on a financing facility or simply an embarrassing mea culpa. If you need assistance in assessing a particular project or the application of a particular method, please contact Bill Klein at CFOs2Go (bklein@cfos2go.com) or by calling him at (925) 890-7521.

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[i] Effective Dates: Public Entities, for annual reporting periods beginning on or after December 15, 2016, and related interim periods; Non-Public Entities, for annual reporting periods beginning on or after December 15, 2017, and interim periods beginning after December 15, 2018.
Early adoption of the new standard isn't permitted for public entities. For all others (nonpublic entities), early adoption is allowed, but no earlier than the effective date for public entities.

[ii] *Will the New Revenue Recognition Rules Impact Your Financials*, Statements, Second Quarter 2016, Jeff Tikalsky, RINA Accountancy Corporation, San Francisco, CA

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