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Revenue Recognition for Construction Clients -- A Blueprint

After years of work, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have issued ASU 2014-09, the Revised Revenue Recognition Model. The model is intended to harmonize what had been a collection of over 200 specialized revenue recognition systems under US GAAP, and provide a more principle-based framework for business in different countries, or in situations not covered by the previous arrangement. While in the long run these revised standards should make revenue recognition both more consistent and more flexible, adoption and application will unquestionably present some challenges, particularly for construction companies.

Because the model represents a significant departure from the previous regime, FASB decided to defer the original effective date by a year. Accordingly, public entities will apply it to annual reporting periods beginning after December 15, 2017. Nonpublic entities have another year, and will be expected to put it into effect after December 15, 2018. For companies with calendar year fiscal years, this effectively means that the new rules go into effect January 1, 2018 for public entities, and January 1, 2019 for nonpublic ones. Transitioning to the new standard will require companies (and their accountants) to review their internal processes and metrics in everything from business development and sales to operations and management, and make guided judgments about their revenue that will power the entire recognition process.

Different industries will be affected in different ways, depending on the source and nature of their revenue. All in all, the goal is a consistent conceptual structure for determining and allocating revenue rather than the previous rules-based as arrangement. At the most fundamental level, the model breaks the recognition process down into five distinct steps:

1. Identify the Contract with a Customer

A contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations.” In other words, the creation of the obligation rather than the actual transfer of funds, is the defining activity, with additional provisions for combining contracts, as well as modifying them with, for instance, change orders in construction projects.

2. Identify the Performance Obligations in the Contract

Identifying the contract's performance obligations, the next step, is guided by another definition, "a promise in a contract with a customer to transfer a good or service to a customer." The term "performance obligation" is a new one, created for this standard. A contract may have several independent obligations, or may have just one, despite specifying several independent activities. For instance, a contractor agrees to demolish an existing road and pave a new one leading to a customer's office building and to construct a new warehouse behind the building. There are two separate performance obligations in the contract: first, the replacement of the road; second, the new warehouse.

3. Determine the Transaction Price

The transaction price, the third element, is a function now of numerous items besides cash consideration, including the time value of money, variable and non-cash consideration, discounts, rebates, commissions and a host of other factors. For example, if a contractor has an 80% chance of receiving a $1 million cash bonus by completing construction of a warehouse ahead of schedule, $800,000 should be added to the calculated transaction price.

4. Allocate the Transaction Price to the Performance Obligations in the Contract

Next, a transaction price needs to be allocated to each performance obligation. The metric here is the standalone selling price for each separate good or service. This can be calculated based on what competitors are selling the same product or service for, or on a cost-plus-reasonable-margin basis, or a residual basis in variable markets.

5. Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

Finally, revenue is actually recognized as of the point when control of the good or service is transferred to the customer – when the customer has the ability to direct the use of, or receive the benefits of, the goods or service. Typically, control passes and revenue is recognized at a contractually specified point in time. However, there are specific situations in which this isn't the case – for example, when the customer receives and consumes a benefit simultaneously (as in a general contractor), the work creates or enhances an asset the customer controls (improving a building enhances the value of the land around it) or the work creates an asset without an alternative use (think of wiring a building). In those cases, where control transfer is less clear, revenue is recognized over time using one of several different general measures of progress, such as costs incurred.

In the context of the updated revenue recognition rules, construction presents several new challenges. One is change orders, which may be treated as new, distinct goods or services requiring new contracts. A change order may also mean replacing an existing contract with a new one, or simply continuing with the existing one. Each has a different impact on revenue recognition.

Other frequently-encountered elements of construction projects may require new revenue treatment, such as mobilization costs, which are now capitalized and amortized, or precontract expenses, which are also amortized as goods and services related to them are transferred.

Transitioning to the new system can require either a full or modified retrospective method, including disaggregated revenue information, current contract balances information, and timing of future revenue recognition. The impact of the transition will affect virtually every aspect of a company's operations, including existing contracts, executive compensation, sales commissions, income taxes, internal control processes and debt covenants, among many.

Operationally, the key to managing the transition is to get out in front of it. We recommend creating an internal team specifically charged with oversight of the implementation, a review of current contracts (or at least a meaningful subset of them) and, when appropriate, guidance from a professional advisor or auditor on particularly complex aspects of the process.

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