Revenue for the engineering and construction industry

The new standard's effective date is coming.

US GAAP

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Revenue viewed through a new lens

Again and again, we are asked what's changed under the new standard: what do I need to tweak in my existing accounting policies for revenue? It's just not that simple.

The new standard introduces a core principle that requires companies to evaluate their transactions in a new way. It requires more judgment and estimation than today's accounting and provides new guidance to determine the units of account in a customer contract. The transfer of control of the goods or services to the customer drives the amount and pattern of revenue recognition; this is a change from the existing risks and rewards model. As a result, there will be circumstances in which there will be a change in the amount and timing of revenue recognition.

Less has been said about disclosures, but the new standard requires extensive new disclosures.

Read this to understand *some* of the most significant issues for the engineering and construction industry – the issues that you should be considering now.

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Identify the contract

New criteria for contract existence may affect the timing of revenue recognition.

Contract existence

Engineering and Construction (E&C) contracts often take a long time to negotiate and may be subject to many approvals in the construction industry. Contractors may therefore start performing work before the contract is legally enforceable (i.e. deemed to exist for accounting purposes). Under the new standard, a contract is an agreement between two or more parties that creates enforceable rights and obligations – contracts can be written, oral or implied by an entity's customary business practices. Enforceability is a matter of law.

Demonstrating that a contract exists under the new standard may prove challenging in some circumstances for the construction industry. Judgment and appropriate evidence, including the potential need for legal advice, may be required to demonstrate that the contract is legally enforceable and meets *all* of the following criteria:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If these criteria are *not* met, the contract does *not* exist for purposes of applying the general model of the new standard. Consideration received from the customer before these criteria are met is generally recognized as a deposit (liability).

Master Service Agreements

Contractors may enter into framework arrangements like Master Service Agreements (MSAs) with customers, and subsequently receive purchase orders (POs) from customers on a periodic basis. An MSA might not meet the new standard's definition of a contract because the MSA itself might not obligate the customer to issue any POs to the contractor or have a substantive penalty for terminating the MSA. In that case, until the contractor receives a PO for services to be performed, a contract does not exist. When this occurs, the PO in combination with the MSA will need to be evaluated to determine whether the criteria listed above are met and a contract exists.

Contract term

The contractual period is the duration of the contract in which the parties to the contract have presently enforceable rights and obligations. If a contract includes a termination penalty clause or a clause with similar economic characteristics, judgment will need to be applied to the facts and circumstances of the clause to determine whether it affects the enforceability of the rights and obligations in the contract. If the termination payment would be considered substantive or cancellation would only occur on some remote contingency, then the contractor would *not* assume cancellation in determining the scope/term of the contract.

Generally in the construction industry, termination for convenience clauses, or a clause with similar economic characteristics will be considered substantive because the rights and obligations under those clauses are akin to a termination penalty. For example, provisions where the contractor is reimbursed for all work completed to date and reimbursed for all demobilization costs associated with leaving the construction site.

For contracts that do not contain termination for convenience clauses or clauses with similar characteristics, judgment will need to be applied to each termination provision to determine the enforceable term. If the termination provision is non-substantive, the contract period will be shorter than the stated term and instead contains options to renew.

Combining contracts

The approach to combining contracts in the new standard is similar but not identical to current US GAAP.

Under current construction guidance, combining contracts is permitted provided that certain criteria are met. The contracts must be: negotiated as a package; function as a single project; require closely interrelated activities; and performed concurrently or in a continuous sequence.

Under the new standard, entities are required to combine contracts if the contracts are entered into at or near the same time with the same customer (or related parties) and *any one* of the following criteria is met:

- contracts were negotiated as a single commercial package;
- consideration in one contract depends on the other contract; or
- goods or services (or some of the goods or services) in the contracts form a single performance obligation.

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Performance obligations

Performance obligations are the new unit of account, which may affect the timing of revenue and margins each period. And tracking costs at this level may make implementation more difficult.

Typically, the unit of account under current construction accounting guidance for measuring contract performance and recognizing revenue is the contract, unless the contract meets the criteria to be segmented[1]. Because segmenting is elective, there is currently diversity in practice.

Under the new standard, entities will need to determine whether goods and services (e.g. engineering services versus construction services) are capable of being distinct, and distinct within the context of the contract. If so, separate units of account may result. A *performance obligation* is the term for the unit of account under the new standard versus the contract or segmented phase of the contract under current accounting.

The new standard requires contractors to assess whether individual promised goods or services are distinct and therefore constitute performance obligations. A good or service is distinct if it meets *both* of the following criteria.

— It is capable of being distinct – can the customer benefit from the good or service on its own or together with other readily available resources?

— It is distinct within the context of the contract – is the entity's promise to transfer the good or service separately identifiable from other promises in the contract?

The unit of account must be carefully considered on a *contract-by-contract basis*, and there may be changes from current accounting. This is because 'distinct' differs from the segmentation criteria and the identification of separate performance obligations is required under the new standard when the goods and services meet the distinct criteria. Contractors will need to use judgment in evaluating whether a good or service is a separate performance obligation.

It is typical in E&C contracts that the finished deliverable consists of a number of subcomponents that normally provide benefit to the customer on their own or together with other readily available resources. Therefore, the evaluation of whether a promised good or service is distinct will likely depend more on whether it is *distinct within the context of the contract*.

The objective when assessing whether an entity's promises to transfer goods or services are distinct within the context of the contract is to determine whether the nature of the promise is to transfer each of those goods or services individually, or whether the promise is to transfer a combined item or items to which promised goods or services are inputs.

The following indicators are designed to assist in evaluating whether two or more promises to transfer goods or services to a customer are *not* separately identifiable – i.e. not distinct within the context of the contract and therefore not separate performance obligations.

— The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output(s) for which the customer has contracted.

— One or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract.

— The goods or services are highly interdependent or highly interrelated, such that each of the goods or services is significantly affected by one or more of the other goods or services.

Typically, under the new standard, goods and services to be provided under an E&C contract will not be separately identifiable or distinct within the context of the contract from the other promises in the contract. Instead, the nature of the promise in the contract is for the contractor to provide a combined item for which the customer has contracted and there is often a *significant integration service* by combining all of the goods and services in the contract into the combined item. However, there may be facts and circumstances where the design and construction of a project are separately identifiable.

If it is determined that a contract contains multiple performance obligations, the contractor will need to allocate the transaction price to each performance obligation generally in proportion to its stand-alone selling price. The stand-alone selling price may not be consistent with the terms or amounts in the contract and judgment will need to be applied in allocating consideration to performance obligations.

Series guidance

Additionally, contractors will need to evaluate whether the promises under the contract meet the criteria to be accounted for as a series. Under the new standard, if goods and services promised in a contract are distinct, substantially the same, meet the over-time criteria (see **Step 5: Recognize revenue**) and have the same pattern of transfer, those goods and services are in the scope of the series guidance; application of the series guidance is not optional. This means that fulfillment of the contract is a single performance obligation.

1. The criteria for segmenting are discussed in paragraphs 605-35-25-10 to 25-13.

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Current US GAAP offers no similar concept to the series guidance.

When evaluating whether it has promised goods or services that are substantially the same, the contractor considers the nature of its promise. If the nature of the promise is to deliver a specified quantity of a good or service, the evaluation considers whether each good or service is substantially the same. If the promise is for the act of standing ready or providing a single service for a period of time, the evaluation considers whether each time increment, rather than the underlying activities, is distinct and substantially the same.

Customer options

An E&C contractor could grant its customer an option to acquire additional goods or services at a discount. For example, a contract with a customer may include the construction of one liquefied natural gas train (train) and contain a customer option for another train at a discount. That option is a performance obligation (the unit of account for revenue recognition) under the contract if it provides a material right that the customer would not receive without entering into that contract. This may represent a change from current accounting.

A material right exists if:

— the discount provides the customer with an option to purchase additional goods or services at a price that does not reflect their stand-alone selling prices; and

— those discounts are only earned as a result of the customer entering into the arrangement.

A material right may not exist if the discounts are provided to customers in the same class regardless of whether they had qualifying prior purchases.

If a material right exists, it is accounted for as a separate performance obligation; this results in revenue being allocated to the option and deferred until the option is exercised or expires. The amount of revenue deferred is based on the relative stand-alone selling price of the customer's option to acquire additional goods or services. If that price is not directly observable, the company will need to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

— any discount the customer would receive without exercising the option; and

— the likelihood that the option will be exercised.

If a material right does not exist, there is no accounting for the customer option when recognizing revenue.

Warranties

Under the new standard, a contractor accounts for a warranty (or part of a warranty) as a performance obligation if the warranty is distinct. This includes when:

— the customer has an option to purchase the warranty separately; or

— additional services are provided as part of the warranty.

The new standard retains the current US GAAP cost accrual model for assurance-type warranties – i.e. warranties that cannot be purchased separately and only provide assurance that the product complies with agreed-upon specifications.

A warranty that provides the customer with a service (e.g. specified tasks or longer than usual coverage periods) is a separate performance obligation, even if it is not separately priced. Assurance warranties, such as warranties for defects, are more common than service warranties in the construction industry.

E&C contractors may use a cost incurred method to measure progress toward complete satisfaction of the respective performance obligation. In that case, they will need to include the assurance warranty cost in their cost-to-cost calculation if they conclude the warranty is not a separate performance obligation.

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Transaction price

New criteria to determine accounting for variable consideration require a change in perspective.

Variable consideration

E&C contracts often contain variable consideration from customers including award fees, claims, unpriced change orders, incentives and penalties that affect the transaction price.

Under current US GAAP, it is presumed that contractors can make reasonably dependable estimates. Consideration in the form of incentive payments and penalties are included in contract revenues if a contractor determines that it is probable it will be entitled to those considerations and the amount can be reliably measured. A claim is recorded as contract revenue when recovery is probable and it can be estimated reliably, but only to the extent of contract costs incurred. Because changes to contract terms need to be 'approved' under the new standard (in addition to other conditions), the timing of recognition of claims may differ from current practice.

The new standard requires contractors to estimate the amount that they expect to be entitled to, including an estimate of variable consideration, to determine the transaction price. Contractors are required to estimate each type of variable consideration using either the expected value or most likely amount method. The expected value method is a probability weighted amount and may be used when there are several possible outcomes, such as with cost-target incentives or liquidated damages. The most likely amount may be used, for example, when the contractor is entitled to receive all or none of a particular incentive.

The amount of variable consideration included in revenue is constrained to the amount that would not result in a risk of significant reversal of revenue.

To assess whether – and to what extent – it should apply this 'constraint', a contractor considers *both* the:

— likelihood of a revenue reversal arising from an uncertain future event; and

— potential magnitude of the revenue reversal when the uncertainty related to the variable consideration has been resolved.

In making this assessment, the contractor uses judgment, giving consideration to all relevant facts and circumstances – including the following factors, which could increase the likelihood or magnitude of a revenue reversal.

— The amount of consideration is highly susceptible to factors outside the contractor's influence – e.g. volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence.

— The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

— The contractor's experience with (or other evidence from) similar types of contracts is limited, or has limited predictive value.

— The contractor has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

— The contract has a large number and a broad range of possible consideration amounts.

Variable consideration is estimated (including use of the constraint) and included in the transaction price at contract inception and updated at each subsequent reporting date using the factors above. Depending on the facts and circumstances of the transaction, revenue for some claims, unpriced change orders and certain contract incentives may be recognized later than under current US GAAP – in some instances close to or on the date of settlement or receipt.

The accounting under the new standard may differ from current US GAAP in certain circumstances because of the constraint on variable consideration guidance. For example, under current US GAAP, the maximum penalty under the contract is used as the estimated penalty if the contractor is unable to make a reasonable estimate. The new standard does not default to the maximum penalty, but instead an entity evaluates the probability and significance of a potential reversal of revenue to determine the estimated penalty.

Noncash consideration

Under the new standard, when customers contribute goods or services (e.g. labor, materials or equipment) to be used in the fulfillment of a contract, those goods or services are accounted for as noncash consideration if the contractor obtains control of those contributed good or services. The evaluation as to whether a contractor obtains control of those goods or services is based on transfer of control guidance and the **principal versus agent** guidance in the new standard. The new standard defines control as the ability to direct the use of, and obtain substantially all of the remaining benefits from, the goods or services.

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Potential indicators that a contractor has obtained control of the contributed goods or services are when:

- the contractor is responsible for the nature, type, characteristics or specifications of the goods or services that the customer furnishes; or
- the contractor is responsible for the ultimate acceptability of performance of the project based on goods or services contributed.

Noncash consideration received from a customer are included in the transaction price at fair value. If a contractor cannot reasonably estimate fair value, it refers to the estimated stand-alone selling price of the promised goods or services.

Significant financing component

Contractors will need to evaluate whether their contractual arrangements with customers provide a significant benefit of financing to either party of the contract at the contract level. If the period between performance and payment for that performance (i.e. whether advance payments or payments in arrears) is one year or more (for reasons other than retainage), significant financing may exist between the parties. The financing component may be explicitly identified in the contract or may be implied by the contract's payment terms.

A contract does not have a significant financing component if the difference between the amount of promised consideration and the cash selling price of the promised goods or services arises *for reasons other than the provision of financing (e.g. retainage)* and the difference between those amounts is proportional to the reason for the difference. In the construction industry, it is a common practice for a customer to withhold an amount of consideration that is payable only on successful completion of the contract or the achievement of a specified milestone. The primary purpose of these payment terms is often to provide the customer with assurance that the contractor will perform its obligations under the contract, rather than provide financing to the customer.

Contractors will be required to adjust the promised amount of consideration for the time value of money if a contract contains a significant financing component.

The new standard provides a practical expedient, whereby an entity is not required to account for the significant financing component if it expects that the period between when it transfers a promised good or service to the customer and when the customer pays for that good or service will be less than one year. Although a construction contract may last more than one year, a contractor may apply the practical expedient when progress payments are being made – i.e. the timing between the transfer of control and the progress payment for that transfer is not expected to exceed one year.

Advance payments

The requirements for advance payments under the new standard are a change from current practice. The changes may particularly affect contracts in which payment is received significantly earlier than the transfer of control of goods or services. For example, contractual payment terms may be aligned with payment schedules to third party suppliers, but the payments may not align with the measure of progress for the transfer of control of goods or services to the customer.

Under current US GAAP, advance payments that do not require repayment in the future, but that will instead be applied to the purchase price of the goods or services involved, are excluded from the requirement to impute interest. This is because the liability (i.e. deferred revenue) is not a financial liability. Examples include deposits or progress payments on construction contracts, advance payments to acquire resources and raw materials, and advances to encourage exploration in the extractive industries.

Under the new standard, when the advance payment is significant to a contract and a contractor concludes that it is receiving financing from the customer, the contractor increases the contract liability and recognizes a corresponding interest expense for the customer payments received before the delivery of the good or service. When it satisfies its performance obligation, the contractor recognizes more revenue than the cash received from the customer, because the contract liability has been increased by the interest expense that has been accreted. Accordingly, this accounting will result in an increase in revenue and an increase in interest expense compared with current US GAAP.

Payments in arrears

Under current US GAAP, when an entity is not in the scope of 'accounting for performance of construction-type and certain production-type contracts', payments in arrears (i.e. extended payment terms) may result in a conclusion that revenue is not fixed or determinable, which precludes revenue recognition. In those circumstances, the entity defaults to a due-and-payable revenue model and does not account for a financing element.

Under the new standard, the transaction price is estimated and a separate evaluation is performed to determine whether the payment terms provide financing to the customer. As a result, the accounting for financing in arrangements when the customer pays in arrears will likely arise more frequently than in current practice. Doing so will result in a decrease in revenue and an increase in interest income compared with current US GAAP.

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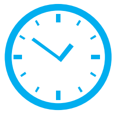
Timing of revenue



Revenue may continue to be recognized over time for most construction contracts, but the timing and amount may change under the new standard.

Over time or at a point in time

Under the new standard, an entity evaluates criteria at contract inception to determine whether it will transfer control of goods and services and therefore satisfy the performance obligation over time. Only if none of the over-time criteria are met, will the contractor recognize revenue at a point in time; see **Step 5: Recognize revenue**.

Many construction contracts will meet one, if not more, of the criteria to recognize revenue over time:

1. the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
2. the entity's performance creates or enhances an asset (e.g. work in process) that the customer controls as the asset is created or enhanced; or
3. the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date (e.g. a right to recover cost incurred plus a reasonable profit margin).

When evaluating "a right to recover cost incurred plus a reasonable profit margin" in the third criterion, the amount to which the entity is entitled does not need to equal the contract margin percentage; instead, it must be based on either a reasonable proportion of the entity's expected profit margin or a reasonable return on the entity's cost of capital. However, if an entity would only recover its costs, then it would not have the right to payment for performance completed to date and this criterion would not be met.

A construction or engineering contract will often meet the second and/or third criterion. In many instances, a contractor creates or enhances an asset in the customer's control (e.g. an asset that is constructed on the customer's land) and so meets the second criterion. Also, an asset created to the customer's specifications will likely have no alternative use to the contractor in its completed state (i.e. the contractor does not have the practical ability to readily direct the asset to another customer), so that the first part of the third criterion will be met. If the contractor is also entitled to payment (inclusive of an appropriate margin) at all times throughout the duration of the contract for work performed that has no alternative use if the contract is terminated by the customer for reasons other than the entity's failure to perform as promised, then the third criterion will be met.

Measure of progress

Many contractors currently apply a percentage-of-completion model to their contracts, and the new standard could bring some change to the measurement of progress. Progress should depict performance in transferring control of goods or services to the customer. If a performance obligation meets the over-time criteria, it is not acceptable to defer all revenue and expense items until the contract is completed.

We expect that many contractors will measure their progress on performance obligations meeting the over-time criteria using an input method such as *cost-to-cost*. Significant judgment may be required in some circumstances, and understanding the nature of its overall promise to the customer is key for the contractor to select a reasonable measure of progress. Contractors should then apply that method consistently to similar performance obligations and in similar circumstances.

Output methods, such as units-of-production or units-of-delivery, unless modified to take into account a measure of progress for work-in-process and finished goods would not depict the transfer of control of goods to the customer.

A contractor applying an input method must exclude the effects of any inputs that do not depict its performance in transferring control of goods or services to the customer. Examples include:

— when an incurred cost does not contribute to an entity's progress in satisfying the performance obligation – e.g. unexpected amounts of wasted materials, labor, or other resources; these costs are expensed as they are incurred and are not used in a cost-to-cost measure of progress; or

— when the cost is not proportionate to the entity's progress in satisfying the performance obligation – e.g. uninstalled materials.

However, many construction contracts are complex and the estimated costs to complete often include some estimate of rework or other costs that are considered in the initial estimate of contract costs. They are not considered wasted costs because they are part of the expected process of designing and completing complex and specialized E&C projects.

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For uninstalled materials, a contractor recognizes revenue only to the extent of the costs incurred – i.e. at a zero percent profit margin, if the contractor expects all the following conditions to be met:

— the good is not distinct;
— the customer is expected to obtain control of the good significantly earlier than it receives services related to the good;
— the cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation; and
— the contractor is acting as the principal, but procures the good from a third party and is not significantly involved in designing and manufacturing the good.

Contractors should also carefully consider whether control of an asset has transferred to a customer when evaluating whether a particular cost has been incurred in satisfying an over-time performance obligation. Consideration of the new standard's point-in-time revenue recognition indicators may be helpful in analyzing whether control has transferred to the customer; see **Step 5: Recognize revenue**. If the contractor still controls the asset (i.e. it has alternative use to the contractor), then it is inventory and not uninstalled materials.

Example – Uninstalled materials

A third party delivered a central heating ventilation and air-conditioning (HVAC) system to the contractor, but the HVAC system could be redirected to other customers without significant cost; in that case, the HVAC system would be inventory and not uninstalled materials related to the contract.

If, however, the HVAC system could not be redirected (e.g. title had passed to the customer, the cost of the HVAC system could be billed to the customer, etc.) then the HVAC system might be uninstalled materials if the cost is significant to the performance obligation and its inclusion in the measure of progress would not appropriately depict the transfer of control of the performance obligation to the customer.

It is not appropriate to record an asset, like work-in-process, for an over-time performance obligation because control generally transfers continuously as the contractor's performance occurs. Instead, contract costs are expensed as a fulfillment cost. Any difference between the measure of performance by the contractor and the consideration that is receivable is presented as a contract asset (see further discussion under **Presentation of contract assets and contract liabilities**).

As a final takeaway, the pattern of revenue recognition using an input method (e.g. cost-to-cost) to measure progress may be similar to the Alternative A percentage-of-completion method used today to estimate revenue earned. However, costs will no longer be adjusted in the percentage-of-completion under Alternative A when contractors use methods other than cost-to-cost to measure their progress under the contract. There is *no equivalent permissible measure of progress to the current GAAP Alternative B gross profit method* under the standard. Measuring progress based on gross profit and costs earned during the period will not be acceptable under the new standard.

The new standard provides no equivalent accounting method to the completed-contract method in current US GAAP if a performance obligation meets the over-time criteria. It is no longer acceptable to defer all revenue and costs until the contract is completed.

Practical expedient (invoice method)

Under current US GAAP, contractors may also provide services that are not construction and record revenue equal to what may be billed to customers per the contract each period. The new standard allows a practical expedient to record revenue based on billings in certain circumstances. If a contractor has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the contractor's performance completed to date (e.g. a service contract in which a contractor bills a fixed amount for each hour of service provided), the contractor may recognize revenue in the amount to which it has a right to invoice.

However, to apply the practical expedient, the contractor should verify that it meets the requirements to apply the expedient. Certain constraints may not allow a contractor to apply the expedient such as contracts that contain a take-or-pay commitment, fixed price, prepayments, contractual penalties (e.g. liquidated damages), award fees, or volume-based incentives (e.g. discounts or rebates). Also, the expedient must apply to the whole contract; it cannot be applied to one performance obligation in a contract with multiple performance obligations for which the amount invoiced to the customer would not be indicative of 'value to the customer' for the whole contract.

Judgment will need to be applied to determine whether the billed amount corresponds directly with the value to the customer; this is particularly if prices change over the contract period.

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Pre-contract activities

The timing for recognizing costs and revenue related to activities before the existence of a contract may change.

Often contractors will incur pre-contract costs or carry out activities before a contract exists to meet anticipated or forecasted demand from customers.

Revenue – If the criteria in **Step 1: Identify the contract** have not been met, any consideration received from the customer is generally recognized as a deposit (liability). When the criteria for contract existence under the new standard are met and performance obligation(s) in that contract meet the over-time transfer of control criteria, revenue for the portion of performance obligation(s) satisfied through the pre-contract activities is recognized on a cumulative catch-up basis on the date it is determined that a contract exists.

Costs[2] – If the pre-contract costs incurred in fulfilling a contract (or anticipated contract) with a customer are outside the scope of other guidance – e.g. inventory, intangibles, research and development, or property, plant and equipment – then an entity recognizes an asset only if the fulfillment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

2. This cost guidance is from Subtopic 340-40, which is new guidance developed in conjunction with the new revenue standard.

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Costs to obtain a contract

Contractors will no longer have the choice to expense commissions as incurred if certain criteria are met.

Under the new standard, *incremental costs* to obtain contracts (e.g. sales commissions or bounties) are required to be capitalized if the contractor *expects the costs to be recoverable*. Costs that will be incurred regardless of whether the contract is obtained (including costs that are incremental to *trying* to obtain a contract) are expensed as they are incurred, unless they meet the criteria to be capitalized as fulfillment costs.

Contractors frequently incur either or both of the following.

— Costs to obtain a customer contract, including renewal contracts and costs to obtain contract modifications, that are incremental (i.e. would not have been incurred but for obtaining the contract) – e.g. sales commissions and fringe benefits directly attributable to payment of that commission, such as additional 401(k) match or payroll taxes. Costs that are not incremental to obtaining a customer contract are expensed as incurred unless capitalized in accordance with other US GAAP. The following are not incremental costs (not exhaustive):

  - costs that are incurred regardless of whether the contract is obtained – e.g. costs incurred in negotiating or drafting a contract;
  - costs that depend on further performance by the commission recipient, such as continued employment at a future date when all or a portion of the commission will be paid; and
  - payments based on operating metrics like EBITDA or operating income that are not solely linked to obtaining one or more customer contracts.

— Costs to fulfill a contract – e.g. costs associated with set-up activities that do not provide a service to the customer in a construction arrangement.

This will be a change for contractors that currently either capitalize bid costs or that expense sales commission costs. A contractor that currently capitalizes the costs to obtain a contract will need to assess whether its current capitalization policy is consistent with the new requirements. For example, a contractor that currently capitalizes incremental bid costs will need to identify those costs that are incremental to obtaining the contract and exclude bid costs that are incurred irrespective of whether the contract is obtained. Likewise, a contractor that capitalizes both incremental and allocable costs of obtaining a contract will need to revise its policy to capitalize only the incremental costs of obtaining a contract.

However, as a practical expedient, a contractor is not required to capitalize the incremental costs to obtain a contract if the amortization period for the asset is one year or less. Similar to the determination for other long-lived assets, the evaluation of the term over which the capitalized asset should be amortized (i.e. over a period greater than a year) should be based on whether the probable future economic benefits obtained or controlled by the entity for the initial asset are commensurate with the initial contact term (e.g. a year) or extend beyond the initial term (i.e. over a period greater than a year).

Currently, some contractors capitalize a portion of an employee's compensation related to origination activities by analogy to current US GAAP addressing loan origination fees. This is not permitted under the new standard, because these costs are not incremental to a specific contract – i.e. an employee's salary and benefits are paid whether or not they successfully solicit a sale.

Accordingly, a contractor that currently capitalizes the costs to obtain a contract will need to assess whether its current capitalization policy is consistent with the new requirements.

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A few other considerations

Contract modifications

There may be a change in the timing of revenue recognition for contract modifications compared to current US GAAP. Change orders are a common form of contract modification for contractors. Guidance in current US GAAP addresses contract modifications for long-term construction- and production-type contracts. The guidance for modifications changes under the new standard and the assessment of whether a contract modification exists focuses on whether the new or amended rights and obligations are enforceable. The following are examples.

- When the customer has approved the scope of a contract change but not the price (i.e. an unpriced change order), the contractor reflects the estimate of the transaction price (see **Variable consideration**) in accounting for the contract modification.
- When neither the scope nor the price of a contract change have been approved – or when either the scope or price are in dispute (i.e. claims) – the contractor evaluates the enforceability of its claim. There may be a difference between a 'legal basis' for a claim (the threshold under current US GAAP) and the modification being legally enforceable, as required under the new standard. Where there is uncertainty about enforceability, written approval and legal interpretation may be required to support a conclusion that the parties to the contract have legally enforceable rights.

Furthermore, under current US GAAP, contractors generally account for a contact modification on a cumulative catch-up basis – i.e. by updating their measure of progress under the contract for the effect of the modification. Under the new standard, a contract modification may be accounted for on a cumulative catch-up basis or prospectively. If the modification to a contract with one performance obligation does not promise additional goods or services, the modification will generally be accounted for on a cumulative catch-up basis. If the modification adds promises to the arrangement that are distinct, generally the contract modification will be accounted for prospectively, with a reallocation of remaining revenue under the original contract if the additional goods or services are not priced at their stand-alone prices.

Provision for losses

Current US GAAP requires a provision for the entire loss on a construction- or production-type contract to be made when the current estimate of total anticipated contract revenue is less than total estimated contract costs. This accounting is unchanged under the new standard.

However, the FASB has proposed a technical correction to clarify that under the new standard a contractor may use either the contract or the performance obligation as the unit of account for measuring the loss.

Allocated contract general and administrative (G&A) costs can be included in the cost bases when calculating whether a contract is in a loss position. That is, a contractor who is including G&A costs today in its loss calculation can continue that practice under the new standard. However, if an E&C contractor wants to change its practice to exclude G&A, the FASB staff has said that this will be acceptable.

Presentation of contract assets and contract liabilities

Under current US GAAP for construction- and production-type contracts, a contractor that applies the percentage-of-completion method recognizes different named assets and liabilities to measure progress than a contractor applying the completed-contract method – e.g. an asset for costs and recognized income not yet billed compared to an asset for the excess of accumulated cost for related billings.

The new standard contains a single, more systematic approach to presentation in the statement of financial position and does not distinguish between different types of contracts with customers. A contractor presents a contract liability or a contract asset in its statement of financial position when either party to the contract has performed. The new standard requires a contractor to present a contract asset or contract liability after at least one party to the contract has performed. The contractor 'performs' by transferring goods or services to the customer, and the customer performs by paying consideration to the contractor. When the contractor's performance exceeds the billable amount, i.e. the right to consideration is conditional on something other than the passage of time, the contractor records a contract asset for the difference. Alternatively, when a customer's payments exceed the contractor's measure of progress, the contractor records a contract liability for the difference.

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However, if the contract is non-cancellable, then the new standard indicates that a contractor recognize a receivable when it is due even if the amount has not been invoiced; this is because the contractor has an unconditional right to consideration. This may be a change to a contractor's classification on the statement of financial position for amounts for which it has an unconditional right to consideration but does not present these amounts as a receivable (e.g. classified in unbilled receivable, costs in excess of billings) under current US GAAP. The current timing of invoices may not reflect when a contractor has an unconditional right to consideration.

A single contract is presented either as a net contract asset or as a net contract liability, even if there are multiple performance obligations. However, if a contractor has multiple contracts, it cannot present on a net basis contract assets and contract liabilities of unrelated contracts – i.e. contracts that cannot be combined under Step 1 (see **Combining contracts**). Therefore, a contractor presents separately total net contract assets from total net contract liabilities, rather than a net position on all contracts with customers.

Additionally, under the new standard, an asset arising from the costs of obtaining a contract or fulfilling a contract is presented separately from the contract asset or liability. This may be a change from current practice for some contractors.

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Applicable to all industries

Expanded disclosures

The new standard contains both qualitative and quantitative disclosure requirements for annual and interim periods. The objective of the disclosures is to provide sufficient information to enable users of the financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Specifically, the new standard includes disclosure requirements for:

- disaggregation of revenue;
- contract balances, including changes during the period;
- performance obligations;
- significant judgments; and
- assets recognized to obtain or fulfill a contract, including changes during the period.

An entity should review these new disclosure requirements to evaluate whether data necessary to comply with the disclosure requirements are currently being captured and whether system modifications are needed to accumulate the data.

Internal controls necessary to ensure the completeness and accuracy of the new disclosures should be considered – especially if the required data was not previously collected, or was collected for purposes other than financial reporting.

Also, SEC guidance requires registrants to disclose the potential effects that recently issued accounting standards will have on their financial statements when adopted[3]. The SEC expects the level and specificity of these transition disclosures to increase as registrants progress in their implementation plans. The SEC has also stated, when the effect is not known or reasonably estimated, that a registrant should describe its progress in implementing the new standard and the significant implementation matters that it still needs to address.

Transition

An entity can elect to adopt the new standard in a variety of ways, including retrospectively with or without optional practical expedients, or from the beginning of the year of initial application with no restatement of comparative periods (cumulative effect method).

Entities that elect the cumulative effect method, are required to disclose the changes between the reported results of the new standard and those that would have been reported under current US GAAP in the period of adoption.

For transition purposes, the new standard introduces a new term – completed contract. A completed contract is a contract for which an entity has recognized all or substantially all of the revenue under current US GAAP as of the date of adoption of the new standard. The concept of a completed contract is used when applying:

- certain practical expedients available during transition under the retrospective method; and
- the cumulative effect method coupled with the election to initially apply the guidance only to those contracts that are not complete.

This will require careful analysis particularly where there is trailing revenue after delivery has occurred (e.g. revenue was not fixed or determinable, collectibility was not reasonably assured, royalty arrangements). In those circumstances, the contract would not be considered complete if substantially all of the revenue had not been recognized before adoption. Applying the standard to these types of contracts at transition may result in revenue being pulled into the opening retained earnings adjustment.

Entities should consider the potential complexities involved with calculating the opening retained earnings adjustment and the recast of comparative periods (if any) when planning their implementation. It may be prudent for entities to perform transition calculations before the adoption date to ensure all potential complexities are identified.

Effective dates

Type of entity	Annual reporting periods after
Public business entities and not-for- profit entities that are conduit bond obligators	**December 15, 2017 including interim reporting periods within that reporting period.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.
All other US GAAP entities, including SEC registrants that are Emerging Growth Companies	**December 15, 2018 and interim reporting periods within annual reporting periods beginning after December 15, 2019.** Early adoption permitted for annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period or interim reporting periods within the annual period subsequent to the initial application.

3. Staff Accounting Bulletin Topic 11.M.

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Some basic reminders

Scope

The guidance applies to all contracts with customers unless the customer contract is specifically within the scope of other guidance – e.g. Topic 944 (insurance), Topic 460 (guarantees).

The new standard applies to contracts to deliver goods or services to a customer. A 'customer' is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

The new standard will be applied to part of a contract when only some elements are in the scope of other guidance.

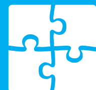
Step 1: Identify the contract

Contracts can be written, oral or implied by an entity's customary business practices, but must be enforceable by law. This may require legal analysis on a jurisdictional level to determine when a contract exists and the terms of that contract's enforceability.

A contract with a customer is in the scope of the new standard when the contract is legally enforceable and all of the following criteria are met:

- the contract has commercial substance;
- rights to goods or services can be identified;
- payment terms can be identified;
- the consideration the entity expects to be entitled to is probable of collection; and
- the contract is approved and the parties are committed to their obligations.

If the criteria are not met, any consideration received from the customer is generally recognized as a deposit (liability).



Step 2: Identify the performance obligations

Performance obligations do not have to be legally enforceable; they exist if the customer has a reasonable expectation that the good or service will be provided. A promise can be implied by customary business practices, policies or statements.

Performance obligations are the unit of account under the new standard and generally represent the distinct goods or services that are promised to the customer.

Promises to the customer are separated into performance obligations, and are accounted for separately if they are both (1) capable of being distinct and (2) distinct in the context of the contract.

An exception exists if the performance obligations represent a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer over time. A series is accounted for as a single performance obligation.

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Step 3: Determine the transaction price

Estimating variable consideration will represent a significant departure from current accounting for many entities.

When determining the transaction price, an entity uses the legally enforceable contract term. It does not take into consideration the possibility of a contract being cancelled, renewed or modified.

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer, excluding amounts collected on behalf of third parties – e.g. some sales taxes. This consideration can include fixed and variable amounts, and is determined at inception of the contract and updated each reporting period for any changes in circumstances.

The transaction price determination also considers:

- **Variable consideration**, which is estimated at contract inception and is updated at each reporting date for any changes in circumstances. The amount of estimated variable consideration included in the transaction price is constrained to the amount for which it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved.
- **Noncash consideration** received from a customer is measured at fair value at contract inception.
- **Consideration payable to a customer** represents a reduction of the transaction price unless it is a payment for distinct goods or services it receives from the customer.
- **Significant financing components** may exist in a contract when payment is received significantly before or after the transfer of goods or services. This could result in an adjustment to the transaction price to impute interest income/expense.

Step 4: Allocate the transaction price

A contractually stated price or list price is not presumed to be the stand-alone selling price of that good or service.

The transaction price is allocated at contract inception to each performance obligation to depict the amount of consideration to which an entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

An entity generally allocates the transaction price to each performance obligation in proportion to its stand-alone selling price. However, when specified criteria are met, a discount or variable consideration is allocated to one or more, but not all, performance obligations.

The stand-alone selling price is the price at which an entity would sell a promised good or service separately to a customer. Observable stand-alone prices are used when they are available. If not available, an entity is required to estimate the price using other techniques – even if the entity never sells the performance obligation separately.

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Step 5: Recognize revenue

An entity must first determine whether a performance obligation meets the criteria to recognize revenue over time.

If none of the over-time criteria are met, revenue for the performance obligation is recognized at the point in time that the customer obtains control of the goods or services.

Control is the ability to direct the use of, and obtain substantially all of the remaining benefits from the goods or services – or prevent others from doing so.

An entity recognizes revenue when it satisfies its obligation by transferring control of the good or service to the customer.

A performance obligation is satisfied ***over time*** if one of the following criteria are met:

— the customer simultaneously receives and consumes the benefits as the entity performs;
— the entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
— the entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date.

If control transfers ***over time***, an entity selects a method to measure progress that is consistent with the objective of depicting its performance.

If control transfers at a ***point in time***, the following are some indicators that an entity considers to determine when control has passed. The customer has:

— a present obligation to pay;
— physical possession;
— legal title;
— risks and rewards or ownership; and
— accepted the asset.

Customer options

Customer options may be accounted for as performance obligations, resulting in more revenue deferral than under current GAAP.

Revenue is allocated to a customer option to acquire additional goods or services, and is deferred until (1) those future goods or services are transferred or (2) the option expires when it represents a material right. A material right exists if the customer is only able to obtain the option by entering into the sale agreement and the option provides the customer with the ability to obtain the additional goods or services at a price below stand-alone selling prices.

Warranties

Warranties do not have to be separately priced to be accounted for as performance obligations.

Assurance-type warranties will generally continue to be accounted for under existing guidance – i.e. Topic 450 (contingencies). However, a warranty is accounted for as a performance obligation if it includes a service beyond assuring that the good complies with agreed-upon specifications. This could require some warranties to be separated between a service element (deferral of revenue which is then recognized as the services are provided) and an assurance element (cost accrual at the time the good is transferred).

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Principal vs. agent

The new standard changes the guidance used to evaluate whether an entity is a principal or an agent. Credit risk is no longer an indicator that an entity is a principal.	An entity identifies each specified good or service to be transferred to the customer, and determines whether it is acting as a principal or agent for each one. In a contract to transfer multiple goods or services, an entity may be a principal for some goods and services and an agent for others. An entity is a principal if it controls the specified good or service that is promised to the customer before it is transferred to the customer. Indicators that an entity has obtained control of a good or service before it is transferred to the customer are having primary responsibility to provide specified goods or services, assuming inventory risk, and having discretion to establish prices for the specified goods or services.

Contract modifications

A general accounting framework replaces specific contract modification guidance for long-term construction- and production-type contracts. However, outside of these arrangements, an entity will find more guidance in the new standard than under current GAAP.	The new standard requires an entity to account for modifications either on a cumulative catch-up basis (when the additional goods or services are not distinct) or a prospective basis (when the additional goods or services are distinct). If any additional distinct goods or services are not priced at their stand-alone selling prices, the remaining transaction price is required to be reallocated to all unsatisfied performance obligations, including those from the original contract.

Contract costs

More costs are expected to be capitalized under the new standard. An entity cannot elect to expense or capitalize. Capitalization is required when the criteria are met.	The new standard provides guidance on the following costs related to a contract with a customer that are in the scope of the new standard: — incremental costs to obtain a contract; and — costs incurred in fulfilling a contract that are not in the scope of other guidance. Incremental costs to obtain a contract with a customer (e.g. sales commissions) are required to be capitalized if an entity expects to recover those costs – unless the amortization period, which may include anticipated contracts or renewals, is less than 12 months. Fulfillment costs that are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant, and equipment – are capitalized if the fulfillment costs: — relate directly to an existing contract or specific anticipated contract; — generate or enhance resources that will be used to satisfy performance obligations in the future; and — are expected to be recovered. An entity amortizes the assets recognized for the costs to obtain and fulfill a contract on a systematic basis, consistent with the pattern of transfer of the good or service to which the asset relates.

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The impact on your organization

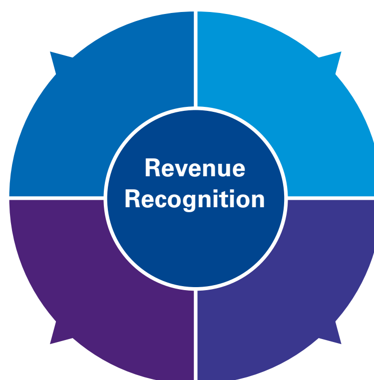
Implementation of the new standard is not just an accounting exercise.

New revenue recognition standard and corresponding accounting changes

- Impact of new revenue recognition standard and mapping to new accounting requirements
- New accounting policies – historical results and transition
- Reporting differences and disclosures
- Tax reporting/planning

Revenue recognition automation and ERP upgrades

- Automation and customization of ERP environment
- Impact on ERP systems
- General ledger, sub-ledgers and reporting packages
- Peripheral revenue systems and interfaces



Financial and operational process changes

- Revenue process allocation and management
- Budget and management reporting
- Communication with financial markets
- Covenant compliance
- Opportunity to rethink business practices
- Coordination with other strategic initiatives

Governance and change

- Governance organization and changes
- Impact on internal resources
- Project management
- Training (accounting, sales, etc.)
- Revenue change management team
- Multi-national locations

As noted in the chart, the new standard could have far-reaching effects. The standard may not only change the amount and timing of revenue, but potentially requires changes in the core systems and processes used to account for revenue and certain costs. Entities may need to design and implement new internal controls or modify existing controls to address risk points resulting from new processes, judgments, estimates and disclosures. The implementation of the new standard will involve a diverse group of parties (e.g. Tax, IT, Legal, Financial Planning, Investor Relations, etc.) and entities should have a governance structure in place to identify and manage the required change. For more information about implementation challenges and considerations, see chapter 14 of KPMG's **Revenue: Issues In-Depth**.

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Keeping you informed

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Revenue: Issues In-Depth	Provides you with an in-depth analysis of the new standard, including our additional insights and extensive examples. Additionally, chapter 14 provides implementation considerations. Our Issues In-Depth is supplemented by Defining Issues as new developments occur.
Revenue: Illustrative disclosures	We show how one fictitious company has navigated the complexities of the revenue disclosure requirements.
Revenue: Transition options	This publication will assist you in identifying the optimal transition method.

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KPMG is able to assist engineering and construction companies as they navigate the adoption of the new standard.

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