Revenue Recognition – Its Here!

Presented by

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VIEWPOINT

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A Moment of Silence

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ASC 606 Begins!

- Required for All Companies that Year ends December 31, 2019 and Beyond
- Principle Based vs Rule Based Approach

Additional Resources for Revenue Recognition Research

https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164076069&acceptedDisclaimer=true

2019 AICPA, Audit & Accounting Guide –Revenue Recognition
Chapter 11, Engineering and Construction Contractors (pp. 611-649)

AICPA –Construction Contractors: Audit and Accounting Guide July 1, 2018
www.aicpa.org

CFMA Revenue Recognition Implementation Guide
www.cfma.org

CICPAC Revenue Recognition Implementation Guide
www.cicpac.com

Read Public Reports

CFMA On-Demand CPE

MUCH ADO ABOUT NOTHING?

PUBLIC COMPANY RESTATEMENTS

	Restatement	Revenue	% of Revenue	100,000,000	50,000,000
Flour	(339,701,000)	19,520,970,000	-1.74%	(1,740,185)	(870,093)
KBR, Inc.	43,000,000	4,913,000,000	0.88%	875,229	437,614
EMCOR Group Inc.	(854,000)	8,130,631,000	-0.01%	(10,503)	(5,252)
Quanta Services, Inc	(1,276,000)	9,466,478,000	-0.01%	(13,479)	(6,740)
Granite Construction Inc.	(15,201,000)	2,989,713,000	-0.51%	(508,443)	(254,222)

5 Step Approach for Achievement!

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

Step 1: Identify Contract

- Commercial substance
- Approval & Commitment
- Legal enforceable rights
- Identifiable Payment Terms
- Probability of Collection

Step 2: Identify Performance Obligation

- Performance Obligation is a contractual promise to transfer a Distinct good or service
- What is Distinct?
  - Customer can benefit from the good or service on its own or with readily available resources
  - The obligation is not integrated, dependent, or interrelated with other promised goods and services or the obligation does not significantly modify other promised goods or services

Step Three : Determine the Transaction Price

- Consideration which an entity expects to be entitled for transferring promised goods or services.
- Variable Considerations – Change Orders/Bonuses/Liquidating Damages/Incentives/Claims/
  - Probability Standard 70-80% likely (Constraining Estimates)
  - Constraining Estimates that it is probable a significant reversal will not occur
- Time Value of Money should be accounted for.
- Non Cash Consideration measured at fair value
- Consideration Payable to the Customer a reduction in revenue.

Step 4 : Allocate the Transaction Price to the Performance Obligations in the Contract

- "For a contract that has more than one performance obligation, an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation."

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

- The customer simultaneously receives and consumes the benefits provided by your performance.
- Your performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- You do not create an asset with an alternative use for you, and you have an enforceable right to payment for performance completed to date.

Indications of control transfer

- Right to payment
- Customer has legal title
- Physical possession of asset has been transferred
- Customer has significant risk & reward of the asset
- Acceptance of the Asset has occurred

The Big Changes!

- Adopting 606
- Determining Performance Obligations
- Change Orders, Claims & LD's
- Recognition of Costs and Gross Profit
- Balance Sheet Presentation
- Disclosures

Adopting 606

- **Modified Retrospective**
  - Apply to Contracts Open at the Beginning of Year (1/1/19)
  - No Restatement of the Comparative Balance Sheet/Income Statement/Cash Flow
- **Full Retrospective**
  - The entity can elect to apply this standard retrospectively to all contracts at the date of initial application

Example of Statement of Stockholders' Equity

	Common Stock		Additional Additional Paid-In Capital	Accumulated Other Comprehensive Income(Loss)	Retained Earnings	Total Stockholders' Equity
	Shares	Amount				
BALANCE AS OF DECEMBER 31, 2018	140,000	$ 1,400	$ 98,600	$ (400,000)	$ 4,000,000	$ 3,700,000
Net Income	-	-	-	-	400,000	400,000
Cumulative adjustment for the adoption of						-
ASC 606	-	-	-	-	(100,000)	(100,000)
Other comprehensive loss	-	-	-	(140,000)	-	(140,000)
BALANCE AS OF DECEMBER 31, 2019	140,000	$ 1,400	$ 98,600	$ (540,000)	$ 4,300,000	$ 3,860,000

Determining Performance Obligations Interrelated, distinct, dependent

- Design Build Contracts vs Design and Build Contracts
- Core & Shell – Tennant Improvement
- The Self Performed Subcontract
- Job Order Cost Contracts
- FASB Default – One Performance Obligation

Change Orders, Claims & LD's Variable Consideration

- Required to estimate variable consideration
- Recognized to the extent that probable significant revenue reversal does not occur. (Constraint)
- Significant?
- Can now book profits on change orders……….
- Reminder Probable is from 70-80%
- Two Methods of Estimation
  - Expected Value
  - Most Likely Amount

Expected Value

- Create a weighted value computation
- Best for Large Number of Outcomes
- More Scientific/Math Driven

	Change Order	$ 100,000.00
Chance	Outcome	
10%	100%	10,000.00
50%	80%	40,000.00
20%	50%	10,000.00
20%	0%	-
100%		$ 60,000.00

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Most Likely

- The single most likely amount in the range of possible outcomes
- Best for fewer (2) outcomes.
- Answer?

	Change Order	$ 100,000.00
Chance	Outcome	
10%	100%	10,000.00
50%	80%	40,000.00
20%	50%	10,000.00
20%	0%	-
100%		~~$ 60,000.00~~

Supports Input or Output Methods

- Input Methods
  - Percentage of Completion
  - Hours Completed
  - Labor Expended
- Output Methods
  - Measured Completion
  - Unit Priced Contracts
  - Product Values

Costs to be Amortized?

- Pre-Construction Work
- Bonding/Mobilization/Design…..
- Amortized over the life of the project
- **Jobs less than one year can elect direct job costing (disclosure required/Practical Expedient)**
- May be subject to Significant Costs only?

Uninstalled Materials

- Recognize Revenue Only on Uninstalled Materials
- What Qualifies for Uninstalled Materials
  - The good is not distinct
  - The customer is expected to obtain control of the good significantly before receiving 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.
  - The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good

Example of Elevator in 606

- The entity assesses whether the costs incurred to procure the elevators are proportionate to the entity’s progress in satisfying the performance obligation in accordance with paragraph 606-10-55-21.
- The customer obtains control of the elevators when they are delivered to the site in Year 1
- The costs to procure the elevators ($1.5 million) are significant relative to the total expected costs to completely satisfy the performance obligation ($4 million).
- The entity is not involved in designing or manufacturing the elevators.
- The entity concludes that including the costs to procure the elevators in the measure of progress would overstate the extent of the entity’s performance.
- The entity recognizes revenue for the transfer of the elevators in an amount equal to the costs to procure the elevators (that is, at a zero margin)

Effect on Income

Example of Elevator

	Total Job	Year 1	Year 2
Revenue	$ 5,000,000	$ 2,200,000	$ 2,800,000
Elevator Costs	$ 1,500,000	$ 1,500,000	$ -
Other Costs	$ 2,500,000	$ 500,000	$ 2,000,000
Total Cost	$ 4,000,000	$ 2,000,000	$ 2,000,000
Gross Profit	$ 1,000,000	$ 200,000	$ 800,000
	20%	9%	29%

WHAT COULD BE UNINSTALLED MATERIALS?

- Elevators?
- Girders?
- Bridge Decking?
- Metal Buildings?
- HVAC Units?
- Electrical Fixture Packages?
- Major Equipment Items?
- Restaurant Equipment?
- Millright?

Lets Ask an Auditor what to DO!

Uninstalled Materials - Audit Procedures

Assertion	What Could Go Wrong in the Financial Statements	Specified Risk Assumptions	Range of Assessed RMM	Audit Procedures Included in Specified Risk Audit Program
E/O	Material costs charged to the job are overstated if uninstalled materials are included in contract costs. Progress of contract may be incorrectly recorded in the financial statements. Damaged or obsolete equipment is overstated.	Primary risk is that contract status may be misrepresented by management. The auditor is unable to overcome the presumption that improper revenue recognition is a fraud risk. Management is not significantly motivated to overstate property.	M to H	Conduct job site visit by touring the construction site, interviewing job site personnel and subcontractors, reviewing contract information on site, etc.

If there are significant amounts of uninstalled or unused materials, perform the following procedures:

a. Obtain job site records of the receiving reports for that material, name of the vendor, and other information to help value the material during subsequent testing of cost-to-cost measure of progress towards completion. Inquire if the material is fabricated specifically for the contract or whether it is material common to most of the entity's contracts.

b. Inquire as to the existence of any materials held offsite that have been specifically purchased for the project.

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Big Changes in Balance Sheet Presentation

- Retention no longer a receivable or a Payable
- Contract Asset or Contract Liability
  - Unconditional Right to receive
  - Break out as Current & Long-term

What a Balance Sheet Might Look Like?

ASSETS	2018
CURRENT ASSETS	
Cash	$ 100,000
Accounts Receivable	
Accounts Receivable-Trade	1,000,000
Accounts Receivable-Retainage	300,000
Total Accounts Receivable	**1,300,000**
Employee Advances	10,000
Costs in Excess of Billing and Estimated Earnings on Uncompleted Contracts	500,000
Prepaid Insurance	50,000
Total Current Assets	**1,960,000**
OTHER ASSETS	
Deposits	10,000

ASSETS	2019
CURRENT ASSETS	
Cash	$ 100,000
Accounts Receivable	1,050,000
Employee Advances	10,000
Prepaid Insurance	50,000
Contract Assets	
Underbilled Revenues	500,000
Retention Receivable Restricted	200,000
Capitalized Job Cost	20,000
Total Contract Assets	720,000
Total Current Assets	**1,930,000**
OTHER ASSETS	
Deposits	10,000
Retention Receivable Restricted	50,000

LIABILITIES	2018
CURRENT LIABILITIES	
Accounts Payable	$ 1,050,000
Subcontractor Retention	350,000
Current Portion Long-Term Debt	250,000
Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	800,000
Other Liabilities	50,000
Total Current Liabilities	**2,500,000**
LONG-TERM LIABILITIES	
Notes Payable Due After One Year	750,000

LIABILITIES	2019
CURRENT LIABILITIES	
Accounts Payable	$ 1,050,000
Subcontractor Retention	100,000
Current Portion Long-Term Debt	250,000
Contract Liabilities	
Overbilled Revenues	800,000
Subcontractor Retention Restricted	200,000
Total Contract Liabilities	1,000,000
Other Liabilities	50,000
Total Current Liabilities	**2,450,000**
LONG-TERM LIABILITIES	
Notes Payable Due After One Year	750,000
Subcontractor Retention	50,000

Disclosures!

- Summary of Significant Accounting Policies:
  - Methods of Recognizing Revenues for Performance Obligations
  - Determining transaction price/performance obligation
  - Types of warranties
- Information on Contracts
  - Provide Information about contract balances, receivables, contract assets and contract liabilities
  - Unapproved change orders, claims…..
  - Provide info about performance obligations and amounts remaining on performance obligations
- Disaggregation of Revenue
- Performance recognized in previous periods.

What Didn’t Change

- Onerous Projects
  - Loss Projects-Loss Still Recognized Once First Known

Quanta Disclosure?

- Some contracts allow customers to withhold a small percentage of billings pursuant to retainage provisions, and such amounts are generally due upon completion of the contracts and acceptance by the customer. Based on Quanta's experience with similar contracts in recent years, the majority of the retainage balances at each balance sheet date are expected to be collected within the next twelve months. Current retainage balances as of December 31, 2018 and 2017 were $337.1 million and $300.5 million and were included in "Accounts receivable." Retainage balances with settlement dates beyond the next twelve months were included in "Other assets, net," and as of December 31, 2018 and 2017 were $99.6 million and $41.9 million.

KBR Disclosure

- As a result of the adoption of ASC 606 on January 1, 2018, unbilled accounts receivable is classified in "Accounts receivable“ in our consolidated balance sheets as it represents the amounts that have been recorded in revenue based on contracted prices for which we have obtained an unconditional right to payment under the terms of our contracts. Retainage is now recorded in "Contract Assets" in our consolidated balance sheets when the right to payment of the retainage is conditional under the terms of our contracts. Prior to the adoption of ASC 606, unbilled accounts receivables were classified as "Costs and estimated earnings in excess of billings on uncompleted contracts" and retainage was classified within "Accounts receivable".

Disclosure from Quanta

- Changes in cost estimates on certain contracts may result in the issuance of change orders and/or claims, which may be approved or unapproved by the customer. Quanta determines the probability that such costs will be recovered based on, among other things, contractual entitlement, past practices with the customer, specific discussions or preliminary negotiations with the customer or verbal approvals by the customer. Quanta recognizes amounts associated with change orders and claims as revenue if it is probable that the contract price will be adjusted and the amount of any such adjustment can be reliably estimated. Most of Quanta's change orders are for services that are not distinct from an existing contract and are accounted for as part of an existing contract on a cumulative catch-up basis. Quanta accounts for a change order as a separate contract if the additional goods or services are distinct from and increase the scope of the contract, and the price of the contract increases by an amount commensurate to Quanta's standalone selling price for the additional goods or services.
- As of December 31, 2018 and 2017, Quanta had recognized revenues of $121.8 million and $144.0 million related to change orders and claims included as contract price adjustments and that were in the process of being negotiated in the normal course of business. These aggregate amounts, which were included in "Contract assets" in the accompanying consolidated balance sheets, represent management's estimates of additional contract revenues that were earned and probable of collection. However, Quanta's estimates could be incorrect and the amount ultimately realized could be significantly higher or lower than the estimated amount.

Disclosure from Granite

- Certain construction contracts include retainage provisions that were included in contract assets as of December 31, 2018 and in receivables, net as of December 31, 2017 in our consolidated balance sheets. The balances billed but not paid by customers pursuant to these provisions generally become due upon completion and acceptance of the project work or products by the owners. As of December 31, 2018 and 2017, no retention receivable individually exceeded 10% of total net receivables at any of the presented dates. The majority of the retentions receivable are expected to be collected within one year and there were no retentions receivables determined to be uncollectible.

Flour Disclosures

- The decrease in retained earnings primarily resulted from a change in the manner in which the company determines the unit of account for its projects (i.e., performance obligations). Under the previous guidance, the company typically segmented revenue and margin recognition between the engineering and construction phases of its contracts. Upon adoption of ASC Topic 606, engineering and construction contracts are generally accounted for as a single unit of account (a single performance obligation), resulting in a more constant recognition of revenue and margin over the term of the contract. In accordance with ASU 2017-13, certain of the company's unconsolidated partnerships and joint ventures will not adopt ASC Topic 606 until the fourth quarter of 2019, at which time the company will record a cumulative effect adjustment which is not expected to be significant.

Disclosure from Flour

- *Warranties*. The company generally provides limited warranties for work performed under its engineering and construction contracts. The warranty periods typically extend for a limited duration following substantial completion of the company’s work on a project. Historically, warranty claims have not resulted in material costs incurred, and any estimated costs for warranties are included in the individual project cost estimates for purposes of accounting for long-term contracts.

Additional Resources for Revenue Recognition Research

https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164076069&acceptedDisclaimer=true

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