



# BKD LLP

CPAs & Advisors

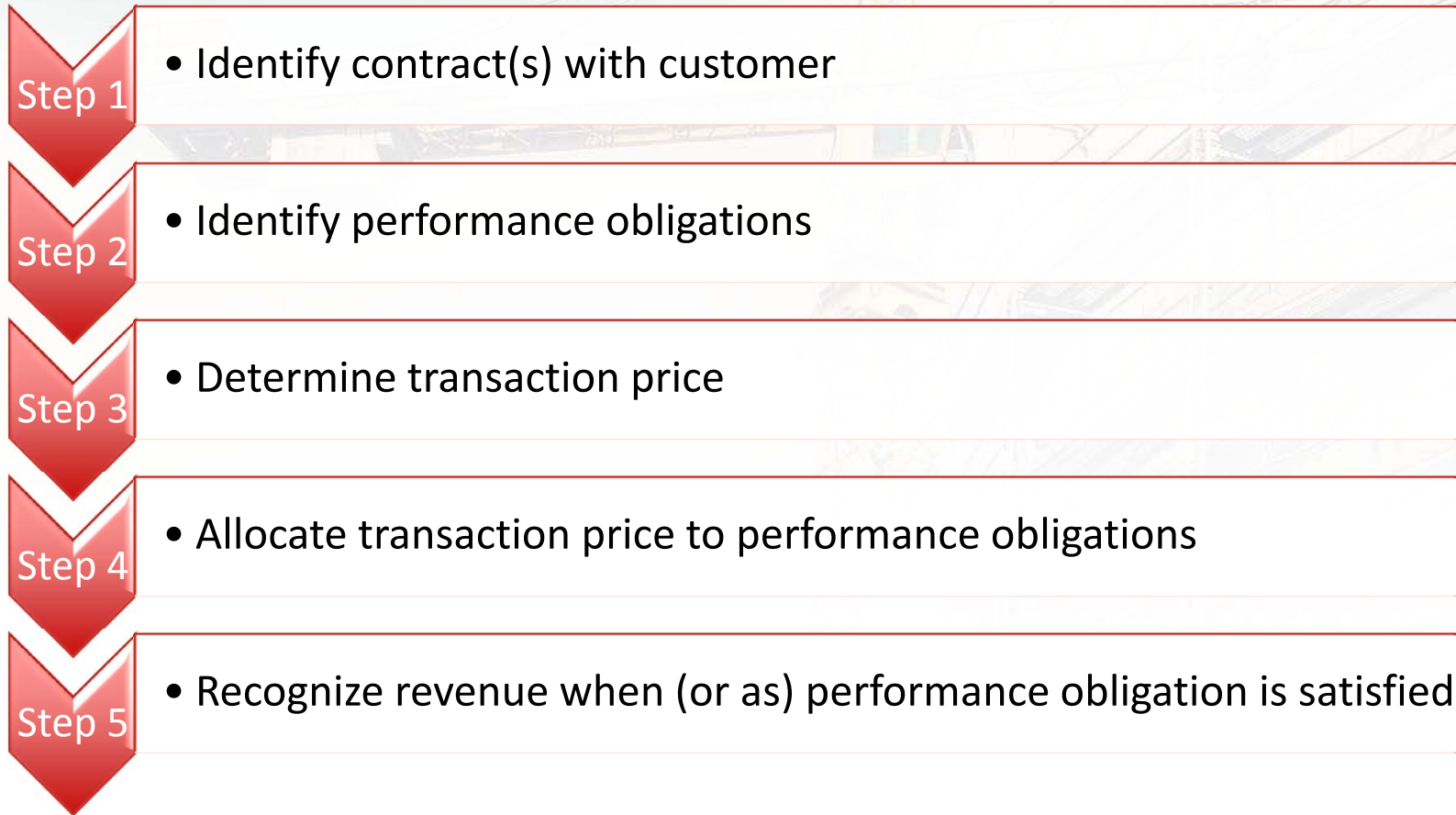


BKD National Construction & Real Estate Group

# Agenda

- Overview of technical standard
- Amendments to date
- Impact on construction accounting
- Implementation action plan
- Industry initiatives
- Q&A

# Five-Step Model



# Construction Will Be Affected More Than Others

Industry	Step 1 Identify Contract	Step 2 Identify Performance Obligations	Step 3 Determine Transaction Price	Step 4 Allocate Transaction Price	Step 5 Recognize Revenue	Contract Costs
Real Estate & Construction	X	X	X		X	X

# Step 1 – Identify Contract(s) with Customer

- Contract = “agreement between two or more parties that creates enforceable rights & obligations” & meets following criteria
  - Commercial substance
  - Approval & commitment by all parties
  - Identifiable rights, obligations & payment terms
  - Collectibility threshold



# Step 2 – Identify Performance Obligations

- Performance obligation
  - Promise to transfer goods/services to customer
  - Can be explicitly identified in contract or implied by customary business practices
  - One contract could equal one or many performance obligations
  - Significant judgment may be required



# Step 2 – Identify Performance Obligations

- Separate performance obligations should be identified if goods or services meet both of following
  - Customer can benefit from good/service on its own or with other readily available resources;
  - Distinct within context of contract, *i.e.*, not highly dependent on or highly interrelated with other promised goods/services in contract



## Step 2 – Identify Performance Obligations

- As a result, expectation is typically one performance obligation for many (not all) construction-type contracts



# Performance Obligations

## ***Fact Pattern:***

- Design/Build contract for new high-rise building
- Contract includes:
  - Engineering
  - Clearance
  - Excavation
  - Soil sampling
  - Foundation
  - Procurement of materials
  - Installation of systems
  - Overall project management

# Performance Obligations

***How many different products & services would you separately account for?***

- One—but why?
  - The goods & services are highly interrelated & interdependent
  - Significant service of integrating goods or services is provided

# Step 3 – Determine Transaction Price

- Transaction price = amount of consideration entity expects to be entitled to (after collectibility threshold is met)
  - Contract terms
  - Customary business practices
  - Time value of money (if significant financing component)
  - Variable consideration (including consideration of constraint) – **awards, incentives, liquidated damages, claims, unpriced change orders**
  - Cash & noncash consideration



# Step 3 – Determine Transaction Price

- Revenue from variable consideration constrained unless
  - Entity has experience with similar contracts & is able to estimate cumulative amount of revenue
  - Based on experience, significant reversal of revenue previously recorded is not probable



# Step 4 – Allocate Transaction Price to Separate Performance Obligations

- Allocate based on relative standalone selling prices of separate performance obligations
  - Observable price when sold separately (best evidence)
  - Otherwise, estimate based on
    - Adjusted market assessment
    - Cost plus margin
    - Residual value – Only if highly variable or uncertain
    - Other



# Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

- Revenue recognized when (or as) control of good/service is transferred to customer
- Transfer of control occurs when customer has ability to direct use of & receive benefits from good/service
- Can be recognized over time or at a point in time, depending on how performance obligations are satisfied



# Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

- Control is transferred **over time** if any of following criteria are met
  - Customer controls asset as it is created/enhanced
  - Customer receives & consumes benefits of entity's performance as entity performs
  - Entity's performance doesn't create asset with alternative use to entity & customer doesn't control asset created; however, entity has right to payment for performance completed to date & expects to fulfill contract



# Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

- Measuring progress toward satisfaction of obligation
  - Output methods
    - Milestones reached
    - Units produced
    - Only used if value of WIP & value of units produced but not yet delivered is immaterial
  - Input methods
    - Costs incurred
    - Machine hours used
    - Time lapsed





# Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

- Control transferred at a **point in time** indicated by following
  - Present right to payment from customer
  - Customer has legal title
  - Customer has physical possession
  - Customer has significant risks/rewards of ownership
  - Customer has accepted asset



# Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied

- Recognize revenue at a point in time only if control doesn't transfer over time
- Factors to consider:
  - Entity has present right to payment
  - Customer has accepted asset
  - Physical possession of asset transferred
  - Customer has significant risk & rewards
  - Customer has legal title to asset

# Contract Costs

- Incremental cost to obtain contract
  - Must capitalize if expected to recover
  - May be expensed if amortization period is one year or less
- Contract fulfillment costs
  - Look to other guidance first (inventory)
  - If not in other guidance, capitalize only if:
    - Relate directly to a contract
    - Relate to future performance
    - Expected to recover

# Financial Statement Disclosures

- Significantly expanded disclosures
- Quantitative & qualitative information about nature, amount, timing & uncertainty of revenue & cash flows
- Limited relief offered to nonpublic companies on some qualitative disclosures

## SEC Disclosure

SEC Regulation S-K currently requires a public company that retrospectively adopts an accounting standard to apply it to all five years of the selected financial data in SEC filings. At a recent meeting, an SEC staff member said the SEC wouldn't object if companies electing retrospective adoption of the new revenue standard only apply the guidance to periods covered by the financial statements presented, rather than all five years. Any additional years included in the selected financial data would not require restatement; however, entities must clearly disclose the inconsistent reporting basis to investors.

# Effective Date & Transition

- Public companies
  - First interim period within annual reporting periods beginning on or after December 15, 2017 (already extended to this date)
  - Early application would be permitted no earlier than original implementation date (periods on or after December 15, 2016)
- Nonpublic entities
  - Additional year after public company effective date
  - Early application permitted as early as public company date

**Do you have a contract in backlog or that you are bidding that will be completed in 2019?**

# Effective Date & Transition

- Two transition options

		2017*	2018*		2019*	Disclosure
<b>Full retrospective method with practical expedients</b>	Cumulative catch-up for completed & existing contracts	Completed & existing contracts restated & presented under new standard			Existing, new & completed contracts restated & presented under new standard	
<b>Modified retrospective method</b>		Existing contracts presented under legacy U.S. GAAP		Cumulative catch-up for existing contracts	Any remaining legacy contract & new contracts under new standard	For each line item effect of applying the ASU vs. not applying

\* **Dates are for nonpublic entities; public organizations will be one year earlier.**

# CHANGES TO ORIGINAL ASU

- ASU 2016-08, Revenue from Contracts with Customers (Topic 606)
  - Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
    - Clarifies implementation guidance on principal vs. agent considerations
    - Provides indicators to assist with determining whether specified good or service is controlled before it is transferred

# CHANGES TO ORIGINAL ASU

- ASU 2016-08, Revenue from Contracts with Customers (Topic 606)
  - Principal versus Agent Considerations (Reporting Revenue Gross versus Net)
    - Key contractor considerations:
      - Significant integration service is provided
      - Inputs are used to create combined output specified
    - Effective for fiscal periods (follows ASU 2014-09):
      - Beginning after December 15, 2017 (public)
      - Beginning after December 15, 2018 (nonpublic)



# CHANGES TO ORIGINAL ASU

- ASU 2016-11, Revenue Recognition (Topic 605) & Derivatives and Hedging (Topic 815)
  - Rescission of SEC Guidance Because of ASUs 2014-09 & 2014-16
    - Upon adoption of ASU 2014-09, Revenue from Contracts with Customers, various items codified
      - Freight services in process
      - Shipping & handling fees & costs
      - Consideration given by vendor to customer

# CHANGES TO ORIGINAL ASU

- ASU 2016-12, Revenue from Contracts with Customers (Topic 606)
  - Narrow-Scope Improvements and Practical Expedients
    - Assessing the collectibility criterion
    - Presentation of sales & other similar taxes
    - Measurement date of noncash consideration
    - Contract modifications at transition
    - Completed contracts at transition

# Update on Rev Rec – Variable Consideration

- Estimate variable consideration by using either of the following methods, depending on which method entity expects to better predict the amount of consideration to which it will be entitled:

## Expected Value

- Sum of the probability-weighted amounts in a range of possible outcomes
- Most predictive when the transaction has a large number of possible outcomes
- Can be based on a limited number of discrete outcomes and probabilities

## Most likely amount

- The single most likely amount in a range of possible outcomes
- May be appropriate when the transaction will produce only two outcomes

# Update on Rev Rec – Variable Consideration

- “Significant” is relative to cumulative revenue recognized on contract
- Impact of claims accounting:
  - It will continue to be acceptable under the new revenue recognition standard to defer the recognition of claim or unapproved claim revenue until it is resolved because there is no new guidance on positive adjustments

# Variable Consideration – Liquidated Damages

**A contractor enters into a contract with a customer to construct a commercial building for fixed consideration of \$25 million. The construction of the building is a single performance obligation that is satisfied over time.**

**The contract requires achievement of substantial completion 104 weeks after receipt of the notice to proceed & assesses \$20,000/day in liquidated damages for each day substantial completion exceeds the target.**

# Variable Consideration – Liquidated Damages

Based on past experience, the contractor incurs liquidated damages on contracts according to the probabilities in the following table.

Possible period of delay	\$ LDs/day	Total \$ LDs	Probability %	Weighted \$ LDs	
0 weeks	0	\$20,000	\$0	30.0%	\$0
1 week	7	\$20,000	\$140,000	12.0%	\$16,800
2 weeks	14	\$20,000	\$280,000	12.0%	\$33,600
3 weeks	21	\$20,000	\$420,000	30.0%	\$126,000
5 weeks	35	\$20,000	\$700,000	12.0%	\$84,000
10 weeks	70	\$20,000	\$1,400,000	2.5%	\$35,000
15 weeks	105	\$20,000	\$2,100,000	0.5%	\$10,500
20 weeks	140	\$20,000	\$2,800,000	0.5%	\$14,000
26 weeks	182	\$20,000	\$3,640,000	0.5%	\$18,200
			<u>100%</u>	<u>\$338,100</u>	

# Variable Consideration – Liquidated Damages

At contract inception, the contract value should be constrained based on the probability of incurring liquidated damages as follows:

Contract amount:	\$25,000,000
Probability weighted LDs:	<u>(\$338,100)</u>
Transaction price:	<u>\$24,661,900</u>

# Update on Revenue Recognition – Disclosures

- Disclosure objective:
  - Provide sufficient information to enable users of financial statements to understand the nature, amount, timing & uncertainty of revenue & cash flows arising from contracts with customers
  - Achieving the objective requires quantitative & qualitative information about:
    - Contracts with customers
    - Significant judgments & changes in judgments when applying guidance to contracts
    - Assets recognized from costs to obtain or fulfill contract



# Update on Revenue Recognition – Disclosures

- Contract assets, liabilities & receivables
  - Assets – Right to consideration in exchange for goods or services that have been transferred to customer
  - Liabilities – Obligation to transfer goods or services to customer for which consideration has been received
  - Receivable – Right to consideration that is conditional only on the passage of time
  - Billed or unbilled
  - Presented net on contract-by-contract basis

# Update on Revenue Recognition – Disclosures

- Private company disclosures
  - Sources of revenues unless presented separately on the face of statement of income
  - Quantitative measures of revenues disaggregated based on timing of transfer of goods or services
    - Over time revenues
    - Point-in-time revenues

# Update on Revenue Recognition – Disclosures

- Private company disclosures
  - Qualitative information about economic factors impacting revenues & cash flows
    - Customer types
    - Geographical locations
    - Types of contracts

# Update on Revenue Recognition – Disclosures

- Private company disclosures
  - Information about performance obligations:
    - When they are typically satisfied
    - Significant payment terms
    - Nature of goods or services
      - Distinguish those where entity is an agent
    - Obligations for returns, refunds, warranties, etc.

# Update on Revenue Recognition – Disclosures

- Private company disclosures
  - Description of method used to recognize revenue & how it is applied to recognize over time
    - Output or input method used to measure revenue
  - Qualitative information about constraint on variable consideration
    - Methods, inputs & assumptions used

# Update on Revenue Recognition – Disclosures

- Private company disclosures
  - Information about contract assets & liabilities
    - Opening & closing balances of receivables, contract assets & contract liabilities not presented separately
    - Impairment losses on receivables & contract assets

# Update on Revenue Recognition – Uninstalled Materials

- AICPA Rev Rec Task Force has prepared an Issues Paper – exposure draft released
- Three basic questions
  - Assessment at contract inception -606-10-55-21(b)
  - Interpretation of “significant”
  - Appropriate accounting once goods are used in satisfying performance obligation

# Update on Revenue Recognition – Uninstalled Materials

- Keep in mind, FASB's goal was to avoid industry-specific issues (one standard for all)
- Day 0, Day 1 and Day 2 Accounting for uninstalled materials
- Final conclusion – need to evaluate closely!!



# Implementation Action Plan

- Assign internal company staff or task force to assess impact on:
  - Accounting
  - Financial reporting
  - Tax
  - Internal audit
  - Contract accounting/job cost/project management
  - IT
  - Legal
  - HR

# Implementation Action Plan

- Evaluate impact on contract accounting
  - Identify contracts
  - Identify performance obligations
  - Calculate contract price
  - Allocate contract price to performance obligations
  - Measure progress to completion

# Implementation Action Plan

- Determine impact of adoption
  - Full retrospective
  - Retrospective with cumulative effect at date of implementation
- Discussions with banks & sureties

# Implementation Action Plan

- Evaluate changes to IT systems
  - Variable consideration
  - Multiple performance obligations
  - Documentation of process
  - Impact at adoption on open contracts
  - Qualitative & quantitative disclosures

# Implementation Action Plan

- Evaluate potential interim disclosures
- Document project plan for implementation
- Educate key stakeholders
  - Board/audit committee
  - Shareholders (if necessary)
  - Banks & sureties
  - Other contractors (GC vs. Sub)

# Q&A