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Topic 606's Impact on Construction Contractors

By Megan Moriarty and James W. Miller | Sunday, April 14, 2019

The adoption of Accounting Standards Codification 606, Revenue from Contracts with Customers (Topic 606), is in full swing. Public companies with a December 31 year-end recently completed more than a year-long (if not years-long) effort to prepare for the adoption of Topic 606, which took effect January 2018. Topic 606 effectively replaces all legacy rules around revenue recognition, making it one of the most time-consuming accounting projects for public companies since the Sarbanes-Oxley Act was enacted more than a decade ago.

The inevitable has now arrived, beginning in 2019, for private companies with December year-ends. What lessons can private companies take from Topic 606 implementation by their public company counterparts?

TOPIC 606 AND CONSTRUCTION

Many private company CFOs and controllers have not thought about Topic 606, primarily because of the false belief that it will not impact them. The first year of implementation with public companies showed Topic 606 impacts everyone.

Based on recent public construction company 10-Q filings, the new revenue recognition standard has had material impacts on the financial statements of all construction companies. That being said, all entities—including construction companies—will need to adopt the new standard and go through the process of analyzing and documenting the five-step model. While it is true that the adjustment to the financial statements of construction companies is not always material, there must be an analysis performed to support this conclusion.

In what areas are public construction projects materially impacted by Topic 606?

- **Master service agreements (MSA)** include providing customers with parts or services at future prices based on past volume. Companies need to evaluate the nature of their promises under a contract, including MSAs, and use judgment to determine whether the contract includes an option to purchase additional goods or services, or a performance obligation for which the quantity of goods or services to be delivered is not fixed at the outset.

- **Variable considerations/constraints** include claims, change orders, incentives, penalties, shared savings, price concessions, liquidating damages, unit price contracts with variable units and more. The company needs to estimate an amount for variable consideration and add it to, or subtract it from, the contract price at the start and throughout the project if the variable consideration is not constrained and no significant revenue reversal is expected. This fact is especially true for longer-length contracts, where accounting is a challenge because, for each reporting period, these constraints will have to be reassessed. A lot of estimation goes into these amounts, making the accounting difficult to predict.
- **Uninstalled materials** were historically included in costs incurred to date on construction contracts, allowing revenue and gross profit recognition. Uninstalled materials should be excluded when measuring progress on a contract. For example, if the windows are ordered and delivered to a jobsite, but not installed at year-end, the cost must be excluded when determining the percent complete on other aspects of a job. The windows would be recorded as a contract cost when they are delivered to the job, at which time revenue is recognized up to the extent of the cost of the windows. The profit on the installation of the windows is deferred until installation occurs. Contract revenues and gross profit from the remaining contract (excluding the windows) will be recognized based on percent complete.
- **Contract fulfillment costs** include costs of obtaining a contract, which need to be deferred and amortized over the life of the contract. The amortization method should be consistent with how revenue is being recognized on the project. These costs are removed from the cost incurred on the project, as they do not provide value to the customer. The company may elect a practical expedient to immediately expense the cost if the amortization period is one year or less. Costs include incremental costs of obtaining a contract, such as sales commissions, bond premiums and mobilization costs.

The loudest message from public companies on the implementation of Topic 606 is that the disclosures required for Topic 606 are exhaustive, and often not quite adequate, even when the underlying analyses were accurate and complete. Nearly all private companies will be affected by the expanded disclosure requirements.

There are some elections that private companies can make to alleviate some of the extensive disclosure requirements, including the following.

- Disaggregated Revenue: Private companies may elect not to apply quantitative disaggregation of revenue; however, if this election is made, the company must at a minimum disclose:
  - Revenue disaggregated according to the timing of transfer of goods or services (at a point in time or over time); and

    - Qualitative information about how economic factors (for example, type or geographical location of customers or type of contract) affect the nature, amount, timing and uncertainty of revenue and cash flows.
- Reconciliation of Contract Balances: Private companies may elect to disclose only the opening and closing balances of contract assets, contract liabilities and receivables with contracts with customers.
- Performance Obligations: Private companies may elect to exclude the transaction price of unsatisfied (or partially satisfied) performance obligations.

The implementation of Topic 606 by public companies during 2018 provided private companies with a significant amount of insight. In addition, subsequent relief and elections granted to private companies help simplify a transition that is anything but easy. However, the transition is necessary; it is incorrect for private companies to conclude that implementing Topic 606 will result in little to no changes without undertaking an analysis.

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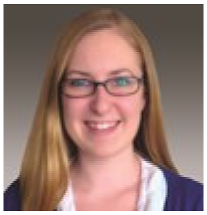

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