

## *Proposed Changes to the Method of Revenue Recognition and its Impact on Contractors*

By: Jay Grant, CPA

The Financial Accounting Standards Board (FASB), in connection with the international accounting standards authority, has proposed changes to the way revenue is recognized for financial statement reporting purposes. The changes, which are driven by the Board's desire to have a single standard for revenue recognition covering all industries. As currently interpreted, the new proposed standard will likely have significant impact on financial statements prepared by contractors. The percentage of completion method, which has been the required approach for many years is being superseded by a new approach, one driven by when the business transfers goods or services to the customer. For contractors this transfer is considered to be of a "performance obligation". While on its face, this seems like an innocuous difference, as applied by the FASB, the results are quite surprising. What drives recognition under the new rules is not the contract, though it plays a part, but rather what is determined to be a performance obligation.

The proposal requires a 5 step analysis:

1. *Identify the contract(s) with the customer.* Identifying the contract is seldom a problem with contractors, though if there are questions, the proposal provides guidance to assist identification.
2. *Identify the separate performance obligations.* These are interpreted to be promises to provide goods or services to the customer. This test is the crux of the problem for contractors. Performance obligations are promises to transfer distinct goods or services. A good is distinct if the good or service is sold or can be sold separately, apparently whether by the contractor in question, or by someone else. It can also be distinct if the good or service has a distinct function (i.e., utility on its own) and has a distinct profit margin (i.e., a company can identify the resources and related risks to provide that product or service).

Thus a single contract to design and build a building could be divided into the design portion (a distinct service that can be sold separately and could have a separate profit margin), the building portion, which could itself be divided into the portion of the contract that requires the builder to perform excavation services and build a foundation and then a separate performance obligation for the framing and so on. The proposal contemplates that each performance obligation will have its own profit margin. The FASB says that using the anticipated profit margin on the entire job is probably not appropriate for determining the profit margin for the separate performance obligations.

3. *Determine the transaction price.* This is the amount of consideration an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract. This in most cases will be the contract price, though the effect of change orders will have an impact. The following will affect the transaction price: collectability which could reduce the contract price (Query: will this require that the reserve for doubtful accounts be allocated to each job?), time value of money (for material financing components), non-cash considerations, and considerations payable to the customer. The contractor will apparently have to assess the likelihood of collecting performance bonuses and include them as well as considering the likelihood of any penalties and include each in the appropriate contract price.
4. *Allocate the transaction price.* The transaction price will be allocated to all performance obligations in proportion to the standalone selling prices of the goods or services underlying each of those performance obligations (i.e., what the good or service could be sold for if sold separately) at contract inception.



5. *Recognize revenue when performance obligations are satisfied.* A performance obligation is satisfied when a good or service is actually transferred to the customer. Transfers to customers focus on when the customer has control (i.e., when the customer has the ability to direct the use of and receive benefit from the good or service). While somewhat unclear, this evidently occurs when each "obligation" is transferred to the owner. So when completed, a performance obligation will trigger the release of the associated revenue to the income statement as well as the associated costs that until that point, were recorded on the balance sheet as an asset. Thus, what is created is a mini series of completed contracts in place of the single percentage of completion reporting.

One reporting possibility which could obviate the results that are described above is the concept of continuous transfer. Performance obligations which occur over a period of time are reportable prorata over the period of performance. In the construction field, equipment rental would be an example. The lessor will report the revenue over the period of use (as it is reported now). However, the FASB has indicated that a construction contract is not of the same type of transfer as the rental of a piece of equipment.

### Disclosures will be the new normal

A simple paragraph explaining your revenue recognition policy is no longer going to be acceptable. In fact, one of the most controversial aspects of this proposal, are the disclosure requirements. The Board is doing a complete overhaul of what has been reported previously. The core objective with disclosures will be to help users of financial statements evaluate the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers.

This means that the Boards will require:

- significant disaggregation of reported revenue;
- a reconciliation of contract assets and liability balances;
- information about performance obligations which would include an estimated time for when long-term contracts will be complete; and
- disclosure of which judgments played a role in applying the standard.

### Summary

The new proposal appears to require a complete change in the mindset of readers of contractors' financial statements. The job schedules, that previously reported a single line for each contract, will likely now require separate lines for each of the performance obligations. This could mean that a single could be divided into 3, 4 or more lines on the schedule. If the guidance which is finally released so indicates, a single contract could have performance obligations that are complete and some that are in process, each of which would have a separate profit margin.

It may be that contractors will just take a GAAP exception in the opinion rather than comply with the new rules.

The entire consequences of the new rules are still unknown, but times have changed for readers of financial statements.

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It's worth knowing that...

- A final Revenue Recognition draft will be available as early as 2011.
- The change in revenue will be treated on a retrospective basis.
- You need to be ready!

