Changes to revenue recognition for construction contractors

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A. Introduction

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that spanned many years. The FASB's Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues, and upon its effective date, replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and SEC Staff Accounting Bulletin Topic 13 (which is also part of legacy GAAP for public entities). As a result, the legacy guidance included in Subtopic 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, is superseded, with the exception of the guidance on recognizing a loss provision on a construction contract, which has been retained (with amendments to make it consistent with the guidance in ASU 2014-09).

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs), certain not-for-profit entities and employee benefit plans, implementation must occur no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either: (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies, which is annual reporting periods beginning after December 15, 2018, and interim periods thereafter.

The FASB amended the guidance included in ASU 2014-09 several times since its issuance, and additional limited changes to that guidance are in process. The new guidance primarily is included within the following sections of the FASB's Accounting Standards Codification (ASC):

- Topic 606, "Revenue from Contracts with Customers"
- Subtopic 340-40, "Other Assets and Deferred Costs – Contracts with Customers"

For a detailed discussion of the new guidance (as amended), refer to A guide to revenue recognition. Additional information is available in our Revenue Recognition Resource Center.

The American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including the Engineering and Construction Contractors Revenue Recognition (ECCRR) Task Force, to identify and provide guidance on revenue recognition implementation issues in specific industries. The AICPA's ultimate objective is to develop a comprehensive nonauthoritative revenue recognition guide that provides helpful discussion and illustrative examples on how to apply the new guidance to contracts in various industries. The AICPA decided to publish content for the guide as it is completed, instead of waiting until all of the content is completed. As a result, the AICPA Audit and Accounting Guide, *Revenue Recognition,* (the Revenue Recognition AAG) has been published, with the most recent version updated in April 2018. The Revenue Recognition AAG includes discussion of: (a) general accounting and auditing considerations related to the new guidance and (b) various industry-specific implementation issues. The AICPA will update the Revenue Recognition AAG with discussion about additional industry-specific implementation issues as the related content is completed. Additional information about the AICPA's industry-specific task forces and its Revenue Recognition AAG can be found on its website.

The ECCRR task force has identified seven implementation issues, all of which have been finalized and are addressed in this paper as follows:

- Impact of termination on contract term: How to determine the term of a contract with a customer under ASC 606, and whether the existence of a specified termination payment/penalty impacts the analysis (see Section C.1.2)
- Identifying a unit of account: How to determine a distinct performance obligation, including accounting for combined contracts (see Sections C.1.3, C.2.2.2 and C.2.2.4)
- Variable consideration: Considerations for estimating the amount of variable consideration and determining the amount of estimated variable consideration to include in the transaction price (see Section C.3.2)
- Acceptable measures of progress: Matters to consider when determining which method to use for measuring progress toward completion of performance obligations satisfied over time, including accounting for service contracts and wasted materials. (see Section C.5.1.3)
- Uninstalled materials: How to account for uninstalled materials, including whether the determination of model applicability is only required at the onset of the contract, whether the model applies to both inventoriable and non-inventoriable materials, and how to account for such materials when installed (i.e., "day 2") (see Section C.5.1.4)
- Contract costs: Accounting for contract costs, including precontract costs and costs that qualify for capitalization (see Section D)
- Balance sheet presentation and disclosures: Considerations for balance sheet presentation and preparing revenue recognition disclosures (see Sections E and F)

B. Construction contractor revenue recognition overview

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services". The objective is met by applying a five-step process requiring the use of judgments, interpretation and estimates, as well as an understanding of significant contract terms. All contacts with customers fall within the scope of ASC 606 except for the following: (a) lease contracts, (b) contracts within the scope of ASC 944, "Financial Services – Insurance," (c) various contractual rights or obligations related to financial instruments, (d) guarantees, except for product or service warranties and (e) certain nonmonetary exchanges. While the scope of ASC 606 is limited to revenue from contracts with customers, many aspects of the guidance in ASC 606 are also applicable to certain transfers of nonfinancial (and in substance nonfinancial) assets to counterparties other than customers.

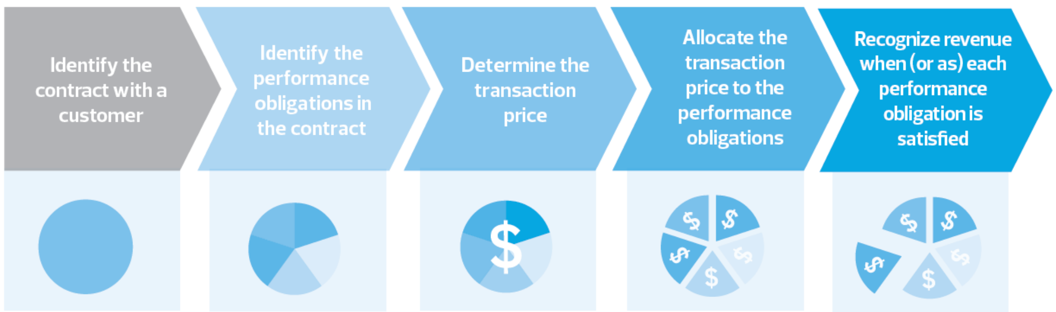
Applying the new guidance to construction contracts could significantly affect the timing and amount of revenue recognized for numerous reasons. For example, the guidance related to segmenting and combining contracts to determine units of account is being replaced with a new model that relies more heavily on the customer's perspective of the transaction.

The accounting model applied to a construction contract will differ under the new guidance. The choice between the two legacy generally accepted methods of accounting for contracts, percentage of completion or completed contract, is being replaced with specific criteria to determine whether to recognize revenue over time or at a point in time. If revenue is recognized over time, a method of measuring progress toward completion will need to be selected, and it may no longer be appropriate to use the cost-to-cost method. Under the new guidance, the amount of revenue recognized in relation to customer consideration paid or recognized as a receivable determines the amount of contract asset or liability. These and other changes result in new qualitative and quantitative disclosure requirements.

ASC 606 may be applied to a portfolio of similar contracts if doing so is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts. If an entity elects this practical expedient, the estimates or judgments it makes in applying ASC 606 to the portfolio of contracts should reflect the portfolio's size and composition. The entity should have support for why accounting for a portfolio of contracts is not reasonably expected to result in materially different outcomes compared to individually accounting for the contracts.

C. Five-step revenue recognition model

The new guidance includes the following five-step revenue recognition model:



An overview of each step together with the ECCRR Task Force's finalized implementation guidance relevant to each step is provided in this section of the white paper. For a comprehensive discussion of the five-step revenue recognition model and other aspects of the new guidance, refer to A guide to revenue recognition.

C.1 Identify the contract with a customer

A contract is defined in ASC 606-10-25-2 as "an agreement between two or more parties that creates enforceable rights and obligations." By definition, an agreement (whether written, oral or implied based on the entity's usual business practices) must be enforceable for it to be considered a contract.

C.1.1 Contract existence criteria

The existence of a customer contract is not enough in and of itself to require application of the remaining steps in the ASC 606 revenue recognition model to the contract. Only if a customer contract meets the following contract existence criteria should it be accounted for in accordance with that model:

- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Commercial substance exists
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur). This is commonly referred to as the collectibility criterion.

While in many cases it will be relatively straightforward for a construction contractor to determine whether a contract exists for accounting purposes, in some cases doing so may be more complex. The degree of complexity depends on the entity's practice for establishing contracts with its customers and how its practices vary depending on the nature of the services provided or other factors. A less complex determination may be involved, for example, in situations where an engineering and construction entity prepares a detailed construction estimate, bid, proposal and contract. Due to the up-front effort put forth, when completed and approved, the contract agreement likely will evidence the payment terms and each party's performance commitments, rights and obligations. A more complex determination may be involved, for example, when the engineering and construction entity enters into oral or implied contracts with clients based on its customary business practices (e.g., beginning work before the paperwork is completed), published policies or specific statements. In these more complex situations, the entity must exercise judgment in determining whether the contract identifies the payment terms and each party's performance commitments, rights and obligations. Ultimately, determining whether an oral or implied contract legally exists and understanding its terms may require the entity to consult with its legal counsel.

C.1.1.1 Assessing collectibility

Collectibility continues to be a criterion that must be met in order for revenue to be recognized. To meet the collectibility criterion in ASC 606, an entity must be able to conclude that, in all probability, a customer has the ability and intent to pay *substantially all* of the amount to which the entity will be entitled in exchange for the promised goods or services *transferred* to the customer. This assessment entails two primary considerations: the amount to which the entity will be entitled and the entity's ability to mitigate credit risk related to the transaction price. If a construction entity's ability to mitigate credit risk has historically been ineffective, for example, the amount determined to be collectible could be less than the transaction price. In such circumstances, the entity would assess whether the collectible amount is substantially all of the amount to which the entity will be entitled. If yes, the entity will recognize revenue based on the amount to which it expects to be *entitled*, without regard to collection risk. Subsequent impairment losses (and reversals) on receivables would be presented as a separate line item from revenue.

A construction entity may be able to mitigate its credit risk by having the contractual and practical ability to cease a project, for example, if the client does not fulfill its obligation to pay for each invoice or payment request within 30 days of receipt. Another method of reducing credit risk is by requiring a client to pay a portion of the estimated fees for services in advance. While the construction entity has mitigated some of its credit risk in this situation, the amount evaluated for collectibility would include the prepaid portion of the transaction price.

If the entity concludes that the amount evaluated for collectibility represents an amount less than all of the promised goods or services in the contract, that conclusion does not affect the requirement to consider all of the promised goods or services in the contract when applying the other provisions of ASC 606. For example, determining the amount evaluated for collectibility generally has no effect on identifying the performance obligations or determining the transaction price.

In evaluating whether collectibility is probable, a construction entity should consider only the customer's ability and intention to pay the amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable, for example, because the entity may offer the customer a price concession. Assessing the probability of collecting substantially all contract consideration for which it will be entitled requires significant judgment from construction entities. Entities will need to evaluate all relevant facts and circumstances, including the contractual terms, the entity's customary business practices and knowledge of the customer. Particularly with "paid when paid" contract provisions, a construction entity may need or want to consider the financial stability of multiple parties (owners, developers and contractors) and the financial viability of the payment chain. Making this determination could involve the entity evaluating its history with that customer and assigning the client to a particular credit risk category.

Example 1: Assessing collectibility in a contract to transfer control of a building in exchange for a 5 percent nonrefundable deposit and long-term financing

The following example is *Example 1—Collectibility of the Consideration*, *Case A—Collectibility Is Not Probable*, from ASC 606-10-55-95 to 55-98:

> An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an

> area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.
>
> The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed.
>
> The entity concludes that not all of the criteria in paragraph 606-10-25-1 are met. The entity concludes that the criterion in paragraph 606-10-25-1(e) is not met because it is not probable that the entity will collect substantially all of the consideration to which it is entitled in exchange for the transfer of the building. In reaching this conclusion, the entity observes that the customer's ability and intention to pay may be in doubt because of the following factors:
>
> a. The customer intends to repay the loan (which has a significant balance) primarily from income derived from its restaurant business (which is a business facing significant risks because of high competition in the industry and the customer's limited experience).
>
> b. The customer lacks other income or assets that could be used to repay the loan.
>
> c. The customer's liability under the loan is limited because the loan is nonrecourse.
>
> The entity continues to assess the contract in accordance with paragraph 606-10-25-6 to determine whether the criteria in paragraph 606-10-25-1 are subsequently met or whether the events in paragraph 606-10-25-7 have occurred.

Given the implications of reaching the appropriate conclusions with respect to whether a contract exists (including whether collectibility is probable) and appropriately estimating the transaction price, engineering and construction entities should make sure they have processes in place to determine whether: (a) all contract existence criteria in the new guidance are met and (b) all discounts, price concessions and other variable consideration has been identified and taken into consideration in estimating the transaction price. This could be a significant undertaking for some engineering and construction entities given that legacy GAAP does not incorporate the same criteria or concepts as ASC 606.

Absent meeting the contract existence criteria, revenue is only recognized when amounts paid by the customer (or by another party on the customer's behalf) are nonrefundable and at least one of the following applies:

- The entity has no remaining performance obligations and it has received all or substantially all of the amounts promised by the customer.
- The contract has been terminated.
- The entity has both: (a) transferred control of the goods or services to which the nonrefundable consideration relates and (b) stopped transferring additional goods or services to the customer and is under no obligation to transfer any additional goods or services to the customer.

Application of the deferral guidance could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

C.1.2 Contract term and the impact of customer termination provisions

Determining the contract term is important because it will affect application of the remaining steps in the five-step revenue recognition model to the customer contract. For example, the contract term will affect the promised goods or services (and performance obligations) identified in Step 2 and the transaction price determined in Step 3.

The contract term is the period of time over which the entity and its customer have present enforceable rights and obligations. Determining this period may be affected by a number of factors, including whether the entity and (or) its customer have termination rights under the contract.

In discussions at the November 2015 FASB Transition Resource Group (TRG) meeting *(TRG Agenda Ref 49, November 2015 Meeting – Summary of Issues Discussed and Next Steps, paragraph 10)*, TRG members highlighted that when performing an evaluation of the contract term and the effect of termination penalties, an entity should consider whether those penalties or other required payments are substantive. If so, the period subject to the substantive termination penalty should be included in the contract term. Otherwise, the period subject to the substantive termination penalty should not be included in the contract term.

As noted in paragraph 11.1.08 of the Revenue Recognition AAG, a contractor's history with terminations in various contract situations, together with its knowledge about the specific customer, should be considered in assessing the termination penalty's impact on a contract's duration. The TRG's discussion on cancellation rights, renewal options and substantive termination penalties is applicable to contracts in which a series of recurring goods and services are being provided. However, contractors generally enter into project design and construction contracts that are rarely terminated because there would be little value to a customer of a partially completed project, and potentially significant costs would be incurred to terminate a project. As a result, the contractor should reflect its obligation to complete the entire project in its accounting treatment. Therefore, the term or duration of the contract should be as defined in the contract assuming no cancellation, until such time that the customer explicitly terminates the contract.

C.1.3 Combining contracts

If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time should be combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective.
- The consideration to be paid under one contract is tied to the other contract's price or performance.
- Some or all of the goods or services in one contract and some or all of the goods or services in the other contract(s) represent a single performance obligation (i.e., some or all of the goods or services in each contract are not distinct from each other).

An example in which separate engineering and construction service contracts are entered into a month apart (at or near the same time) is noted in paragraph 11.1.02 of the Revenue Recognition AAG. If these two contracts pertained to the same capital asset and would be one performance obligation (see Section C.2) if they were both included in the same contract, the contracts likely should be combined.

The requirement to combine contracts in certain situations for purposes of identifying a contract has no effect on an entity's requirement to separate promises to transfer goods or services into performance obligations. If a promised good or service within a combined contract meets the criteria for being distinct, it should be accounted for separately as a performance obligation.

This new guidance differs from legacy GAAP in which the ability to combine contracts was generally optional.

C.1.4 Contract modifications

Contract modifications occur when the entity and its customer agree to add or change enforceable rights and obligations in the contract (e.g., changes to the contract's scope and [or] price). The decision to add or change the contract's enforceable rights and obligations may be a normal part of the construction contractor's relationship with its customer (e.g., change orders), or the decision may result from a dispute between the parties (e.g., resulting in liquidated damages or claims). While in some cases it will be clear that the enforceable rights and obligations in the contract have been changed and agreed to by the construction contractor and its customer, in other cases it may not be so clear. In those cases where it is not clear, the entity should ensure it has considered all relevant facts and circumstances (including its customary business practices) and then carefully exercise judgment to determine whether the rights and obligations in the contract have changed and whether those changes are enforceable (which may require consultation with legal experts). Understanding whether the changes are enforceable is important because changes that are not enforceable do not give rise to changes in the accounting for the contract.

A contract modification may exist even though the parties to the contract have a dispute about the modification's scope or price (or both). Contract modifications in the engineering and construction industry result from a variety of provisions, including change orders or target penalties and incentives relating to factors such as completion dates, plant capacity upon project completion, and underruns or overruns of estimated costs, among others. The accounting model applied to a contract modification depends on a number of factors, including the pricing of the modification, whether any new products or services added by the modification are distinct and whether any remaining goods or services are part of a partially satisfied single performance obligation. Analysis of these elements will determine whether the modification should be accounted for as (a) a separate contract, (b) the termination of one contract and execution of a new contract (prospective treatment) or (c) an adjustment to the original contract (resulting in a cumulative catch-up adjustment).

Spotlight on change

Under ASC 605-35, approved contract modifications involving scope and price generally are accounted for by adjusting contract revenue and costs. ASC 605-35 provides detailed guidance for unpriced change orders, claims and contract options and additions. ASC 606 includes specific guidance about accounting for contract modifications and contract options that is significantly different from the guidance in ASC 605-35. With respect to contract modifications, this difference arises because ASC 606 ties the accounting for certain contract modifications to its guidance on whether promised goods or services are distinct and accounting for variable consideration. Construction contractors should expect to devote additional resources to identifying and analyzing contract modifications and accounting for them in accordance with the specific guidance in ASC 606.

C.1.4.1 Change orders

The accounting for change orders depends on the modification's underlying facts and circumstances. A change in a contract's original scope or price provisions, or both, may be approved, unapproved or in dispute. It may be initiated by the contractor or the customer. In determining whether the created or modified rights and obligations effected by a change order are enforceable, a construction contractor should consider all relevant facts and circumstances including the terms of the contract and other evidence. As noted in paragraph 11.3.09 of the Revenue Recognition AAG, some of the factors to consider include:

- The customer's written approval of the change order's scope
- The existence of current contract language that indicates clear and enforceable entitlement relating to the change order
- Separate documentation for the change order's costs that are identifiable and reasonable
- The entity's favorable experience in negotiating change orders, particularly in relation to the contract and change order under evaluation

Construction contractors will need to determine whether the change order is legally enforceable. The variable consideration guidance should be applied to enforceable unpriced change orders – the common scenario in which a change order defines the work to be performed but adjustment of the contract price is negotiated later (unpriced change orders are discussed in Section C.3.2.3). As a matter of best practice, entities should have in place policies and procedures to capture change orders, including oral agreements, and document their approval, including which individuals, or level of individuals, have the right to bind each party to the contract.

Example 2: Accounting for a contract modification in which the promised goods and services in a construction contract are a single performance obligation before and after the modification

The following example is *Example 8—Modification Resulting in a Cumulative Catch-Up Adjustment to Revenue* from ASC 606-10-55-129 to 55-133:

An entity, a construction company, enters into a contract to construct a commercial building for a customer on customer-owned land for promised consideration of $1 million and a bonus of $200,000 if the building is completed within 24 months. The entity accounts for the promised bundle of goods and services as a single performance obligation satisfied over time in accordance with paragraph 606-10-25-27(b) because the customer controls the building during construction. At the inception of the contract, the entity expects the following:

Transaction price	$1,000,000
Expected costs	700,000
Expected profit (30%)	$300,000

At contract inception, the entity excludes the $200,000 bonus from the transaction price because it cannot conclude that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. Completion of the building is highly susceptible to factors outside the entity's influence, including weather and regulatory approvals. In addition, the entity has limited experience with similar types of contracts.

The entity determines that the input measure, on the basis of costs incurred, provides an appropriate measure of progress toward complete satisfaction of the performance obligation. By the end of the first year, the entity has satisfied 60 percent of its performance obligation on the basis of costs incurred to date ($420,000) relative to total expected costs ($700,000). The entity reassesses the variable consideration and concludes that the amount is still constrained in accordance with paragraphs 606-10-32-11 through 32-13. Consequently, the cumulative revenue and costs recognized for the first year are as follows:

Revenue	$600,000
Costs	420,000
Gross profit	$180,000

In the first quarter of the second year, the parties to the contract agree to modify the contract by changing the floor plan of the building. As a result, the fixed consideration and expected costs increase by $150,000 and $120,000, respectively. Total potential consideration after the modification is $1,350,000 ($1,150,000 fixed consideration + $200,000 completion bonus). In addition, the allowable time for achieving the $200,000 bonus is extended by 6 months to 30 months from the original contract inception date. At the date of the modification, on the basis of its experience and the remaining work to be performed, which is primarily inside the building and not subject to weather conditions, the entity concludes that it is probable that including the bonus in the transaction price will not result in a significant reversal in the amount of cumulative revenue recognized in accordance with paragraph 606-10-32-11 and includes the $200,000 in the transaction price. In assessing the contract modification, the entity evaluates paragraph 606-10-25-19(b) and concludes (on the basis of the factors in paragraph 606-10-25-21) that the remaining goods and services to be provided using the modified contract are not distinct from the goods and services transferred on or before the date of contract modification; that is, the contract remains a single performance obligation.

Consequently, the entity accounts for the contract modification as if it were part of the original contract (in accordance with paragraph 606-10-25-13(b)). The entity updates its measure of progress and estimates that it has satisfied 51.2 percent of its performance obligation ($420,000 actual costs incurred ÷ $820,000 total expected costs). The entity recognizes additional revenue of $91,200 [(51.2 percent complete × $1,350,000 modified transaction price) – $600,000 revenue recognized to date] at the date of the modification as a cumulative catch-up adjustment.

Example 3: Accounting for a disputed contract claim involving a change to the contract price

The following example is *Example 9—Unapproved Change in Scope and Price* from ASC 606-10-55-134 to 55-135:

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

RSM commentary: While the entity has incurred costs due to the delay in getting access to the customer-owned land, incurrence of those costs does not result in the transfer of promised goods or services in the contract, so no revenue should be recognized upon filing the claim with the customer. Hence, if the entity uses a cost-based measure of progress toward completion of the contract, it will exclude from that measure the costs associated with the delay (see Section C.5.1.4).

Because the entity has enforceable rights under the contract to file a claim for the delay costs it incurred, it generally would add the claim amount to the transaction price as variable consideration. The entity should estimate the amount of the claim using either the most likely amount method or the expected value method (see Section C.3.2.1) and include the estimate in the transaction price (subject to the variable consideration constraint discussed in Section C.3.2.2).

C.2 Identify the performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the contract. Once that step is complete, criteria are applied to determine whether the promises to provide goods or services should be treated as performance obligations and accounted for separately.

Spotlight on change

The basic presumption under legacy GAAP for construction contractors is that each contract is the profit center for revenue recognition, cost accumulation and income measurement, with provisions for combining a group of contracts or segmenting a single contract or group of combined contracts if certain criteria are met. The criteria used to determine whether a contract may be segmented for accounting purposes under ASC 605-35 are different from the criteria used to identify performance obligations under ASC 606. In addition, if the segmentation criteria in ASC 605-35 are met, the construction contractor is permitted, but not required, to segment the contract.

Conversely, under ASC 606, when a promised good or service meets the criteria for being distinct, it is accounted for separately as a performance obligation (with one limited exception). In other words, if the promised good or service meets the criteria to be considered distinct, the construction contractor does not have a choice regarding whether to account for it separately. Construction contractors will need to change their financial reporting processes and internal controls to focus on identifying performance obligations instead of contract segments. This change could lead to the identification of different units of account for revenue recognition purposes, which could lead to changes in the amount of revenue and gross profit recognized in a particular reporting period.

C.2.1 Identifying promises to transfer goods or services

An entity should scrutinize its customer contracts and identify all promises to transfer goods or services to the customer. Not all activities performed by the entity in connection with the customer contract transfer a good or service to the customer. For example, setup activities do not transfer a good or service to the customer. Instead, those activities are necessary for the entity to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation for which revenue is recognized. However, depending on the facts and circumstances, the entity may be required to capitalize the costs to perform these activities under ASC 340-40 (see Section D.1).

Construction contractors should give consideration to whether there are promises to transfer goods or services that arise out of an entity's customary business practices instead of an explicit contract provision. If an entity's customary business practice, published policy or specific statement creates a valid expectation on the customer's part to receive a good or service from the entity (e.g., training on how to use purchased equipment), an implicit promise to transfer goods or services exists that should be accounted for just like explicit promises to transfer goods or services.

C.2.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and treated separately for accounting purposes. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct and accounted for separately as a performance obligation unless the series exception applies (see Section C.2.2.1)

- *Capable of being distinct*. If a customer can benefit from the promised good or service (or a bundle of goods or services) on its own or by combining it with other resources readily available to the customer, then the good or service is capable of being distinct. A promised good or service is capable of being distinct when the entity regularly sells that good or service separately or when the customer can generate an economic benefit either on its own or when combined with other readily available resources. The ability to sell the good or service for scrap value only would not, in and of itself, support a conclusion that the promised good or service is capable of being distinct. For a resource to be readily available to the customer, it must be sold separately either by the entity or another party or it must be a good or service that the customer already has obtained as a result of either a contract with the entity (including the contract under evaluation) or another transaction or event.

- *Distinct within the context of the contract*. If the promised good or service is separately identifiable from other promised goods or services in the contract, it is distinct within the context of the contract. To determine whether a promised good or service is distinct within the context of the contract, the entity must ascertain which of the following best describes its promise within the context of the specific contract:
  - *The promise within the context of the specific contract is to transfer the promised good or service individually*. If this best describes the entity's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
  - *The promise within the context of the specific contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the entity's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the context of the contract:

- Is the entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services?

If a promised good or service is not distinct, it is combined with the other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the contract.

Example 4: Identifying the promised goods or services and performance obligations in a contract to build a hospital

The following example is *Example 10—Goods and Services Are Not Distinct*, *Case A—Significant Integration Service*, from ASC 606-10-55-137 to 55-140:

> An entity, a contractor, enters into a contract to build a hospital for a customer. The entity is responsible for the overall management of the project and identifies various promised goods and services, including engineering, site clearance, foundation, procurement, construction of the structure, piping and wiring, installation of equipment, and finishing.
>
> The promised goods and services are capable of being distinct in accordance with paragraph 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that the entity, or competitors of the entity, regularly sells many of these goods and services separately to other

customers. In addition, the customer could generate economic benefit from the individual goods and services by using, consuming, selling, or holding those goods or services.

However, the promises to transfer the goods and services are not separately identifiable in accordance with paragraph 606-10-25-19(b) (on the basis of the factors in paragraph 606-10-25-21). This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted.

Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

RSM commentary: Whether revenue for the single performance obligation in this example should be recognized over time or at a point in time is addressed in Section C.5.1.

The importance of properly identifying the performance obligation(s) in a contract becomes clear when considering how the accounting for the contract would differ if the entity reached an improper conclusion about identified performance obligation(s). In this example, reaching an improper conclusion could have resulted in the entity identifying multiple performance obligations (e.g., one for each promised good or service) instead of a single performance obligation. If multiple performance obligations had been improperly identified, the entity would have had to estimate the standalone selling prices of each performance obligation and allocate the transaction price to each performance obligation using the relative standalone selling price method (see Section C. 4) and determine whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point time (and if so, the point in time control of the underlying goods or services transfers to the customer). Improperly accounting for the contract in this manner would likely provide significantly different accounting results compared to properly accounting for the contract as one with a single performance obligation.

C.2.2.1 Series of distinct goods or services

If a promised good or service is distinct, it is considered a performance obligation to be accounted for separately. However, a series of distinct promised goods or services that is substantially the same should be considered a *single* performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of: (a) each of the goods or services otherwise being considered satisfied over time (see Section C.5.1) and (b) the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services (see Section C.5.1.3). This exception is commonly referred to as the series exception.

Within the engineering and construction industry, a common example of a scenario that would meet the series exception would be an operations and maintenance contract for daily maintenance services that are substantially the same (e.g., a stand-ready contract where the construction entity's performance of standing ready is the same from day to day).

C.2.2.2 Significant integration services

A construction contractor's evaluation of whether phases of a construction contract provide benefit to the customer on their own or together with other readily available resources within the context of the contract will likely vary depending on the specific circumstances of the contract.

As noted in paragraph 11.2.08 of the Revenue Recognition AAG, an important factor in determining whether goods or services should be combined with integration services (e.g., contract management services) into a single performance obligation is whether the integration service risks are inseparable from the risks involved in transferring the other promised goods or services. A contract's acceptance or warranty provisions can provide insight into this evaluation.

Further, careful consideration should be given to the significance of integration services in situations in which there are services being provided or structures being built.

C.2.2.3 Significantly modify or customize

Specific facts and circumstances should be considered and judgment is required when determining whether the promised good or service significantly modifies or customizes one or more other promised goods in the contract. For example, engineering work that modifies or customizes a construction project, if significant, would indicate that the engineering service is likely not distinct within the context of the contract from the construction services. Particularly for situations in which it is not unusual for engineering to modify or customize a construction site, this evaluation criterion should be given extra attention and should consider the construction contractor's own facts and circumstances.

C.2.2.4 Highly interdependent or highly integrated

The FASB noted in paragraph BC111 of its basis for conclusions for ASU 2014-09 that the "highly interdependent or highly integrated" indicator is included to help clarify those situations in which it is unclear whether the significant modification or significant integration indicators are met. As noted in paragraph 11.2.13 of the Revenue Recognition AAG, for construction contractors, it is usually clear whether the significant integration and modification indicators are met. As a result, the "highly interdependent or highly integrated" indicator typically will not be as important for construction contractors to evaluate.

C.3 Determine the transaction price

C.3.1 General requirements

The transaction price, which is the amount ultimately recognized as revenue under the new guidance, is defined in ASC 606-10-32-2 as "the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes)." In addition to the contract terms, the entity's customary business practices also should be taken into consideration in determining the transaction price. The transaction price includes or could be affected by one or more of the following:

- Fixed cash consideration
- Variable consideration
- Noncash consideration
- Significant financing component
- Consideration payable to the customer

Issues encountered by construction contractors in determining the transaction price typically involve variable consideration and potentially significant financing components, which are discussed in more detail in Sections C.3.2 and C.3.3, respectively.

C.3.2 Variable consideration

Variable consideration in the engineering and construction industry can take many forms, including various change orders (approved, unapproved, priced, unpriced), extras, liquidated damages, discounts, price concessions, claims, back charges, contractual allowances and provisions for penalty and incentive payments, including award fees and performance and cost-target incentives. The variability in the amount of consideration payable by the customer may be stated in the contract, or it may be caused by an implicit price concession that the entity intends to offer the customer or that the customer has a valid expectation of receiving based on the entity's customary business practices, published policies or specific statements. The variability in the consideration could affect whether the entity is entitled to the consideration (e.g., achieving or not achieving a deadline to which a performance bonus is tied) and (or) the specific amount of consideration the customer ultimately will have to pay (e.g., the performance bonus to which an entity will be entitled depends on how early it is able to complete the project).

For variable consideration other than a sales or usage-based royalty for which the only or predominant item to which the royalty relates is the license of intellectual property, determining the amount of variable consideration that should be included in the transaction price typically involves the following two steps: (1) estimating the variable consideration to which the entity expects to be entitled (see Section C.3.2.1). and (2) constraining the amount of variable consideration such that it is probable that the inclusion of the estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved, (see Section C.3.2.2).

Example 5: Identifying variable consideration in a contract with a penalty

The following example is *Example 20—Penalty Gives Rise to Variable Consideration* from ASC 606-10-55-194 to 55-196:

> An entity enters into a contract with a customer to build an asset for $1 million. In addition, the terms of the contract include a penalty of $100,000 if the construction is not completed within 3 months of a date specified in the contract.
>
> The entity concludes that the consideration promised in the contract includes a fixed amount of $900,000 and a variable amount of $100,000 (arising from the penalty).
>
> The entity estimates the variable consideration in accordance with paragraphs 606-10-32-5 through 32-9 and considers the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

C.3.2.1 Estimating variable consideration

One of two methods must be used to estimate the variable consideration to which the entity expects to be entitled: (a) the most likely amount method or (b) the expected value method. The entity must use the method that is expected to better predict the amount to which the entity expects to be entitled. In applying either of these methods, the entity should consider all reasonably available information (historical, current, and forecasted) along with a reasonable number of possible consideration amounts. A construction contractor is likely to use information for estimation purposes similar to that used in bid and proposal processes, analyzing information used to determine contract prices, as well as its history with the type of variable consideration in similar situations. In addition, the same estimation method should be used when accounting for contracts with similar characteristics in similar circumstances. However, to the extent a contract includes two different variable payment streams based on the resolution of different uncertainties, the facts and circumstances may support using different methods to estimate the variable consideration expected upon the resolution of each uncertainty.

ASC 606 does not provide any hard-and-fast rules related to when the expected value method or most likely amount method would provide the best prediction. However, the use of the most likely amount method may be appropriate when few outcomes are possible, such as when estimating a fixed-amount performance bonus (e.g., the bonus is 100% or nothing). Further, the use of the expected value method, which involves applying probability weighting to several possible outcomes, may be appropriate when there are a large number of contracts with similar characteristics or there is a wide range of possible outcomes, such as for cost-target incentive and liquidated damage variable consideration scenarios on multiple similar contracts, among others.

The estimated variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. The method used to initially estimate the variable consideration also should be used when the estimate is reassessed each reporting period. To the extent a construction contractor's estimates of the amounts it expects to collect change frequently or change to a significant extent, it should reassess the estimation process it has in place for variable consideration, including the variable consideration constraint discussed in Section C.3.2.2.

To illustrate the two methods that may be used to estimate the amount of variable consideration to which the entity expects to be entitled, and the difference between them, consider the following example.

Example 6: Illustrating how to estimate variable consideration using the expected value method and the most likely amount method

Company A enters into a contract to construct a building for Customer B. Company A commits to turning control of the building over to Customer B no later than June 30, 20X1. In return, Customer B agrees to pay $1 million for the building. To incent Company A to turn control of the building over to it sooner, Customer B agrees to pay Company A an additional $250,000 for each week before June 30, 20X1 that Company A turns control of the building over to Customer B. However, the total incentive payment cannot exceed $500,000. Company A assigns the following probabilities to Customer B owing $0, $250,000 or $500,000 in variable consideration, which results in the following estimates of variable consideration using the expected value method and most likely amount method:

Delivery occurs…	Incentive payment	Probability	Probability-weighted average
On June 30, 20X1 or less than one week before	$ -	20%	$ -
At least one week before, but less than two weeks before, June 30, 20X1	$250,000	20%	50,000
Two weeks or more before June 30, 20X1	$500,000	60%	300,000
Variable consideration estimated using the expected value method			$350,000
Variable consideration estimated using the most likely amount method			$500,000

Company A does not have a free choice with respect to using either the expected value method or most likely amount method. It must analyze all of its facts and circumstances and determine which method better predicts the amount of variable consideration in those facts and circumstances. Making this determination will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

Application of the variable consideration constraint (see Section C.3.2.2) was not applied to this example.

C.3.2.2 Variable consideration constraint

Once the entity has estimated the amount of variable consideration to which it expects to be entitled, it then needs to apply the constraint focused on whether it is probable that the inclusion of the estimated variable consideration in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved. Only estimated variable consideration for which it is probable that its inclusion in the transaction price will not result in a significant reversal of cumulative revenue recognized should be included in the transaction price. If it is probable that a significant reversal of cumulative revenue recognized will not occur with respect to just a portion of the estimated variable consideration to which the entity expects to be entitled, that portion would be included in the transaction price.

The TRG discussed whether the constraint on variable consideration should be applied at the contract level or the performance obligation level. The basis for its conclusions is provided in TRG 14, and the summary of discussions is provided in TRG 25 paragraph 49 as follows:

> …TRG members generally agreed that the constraint on variable consideration should be applied at the contract level. Therefore, the assessment of whether a significant reversal of revenue will occur in the future (the constraint) should consider the estimated transaction price of the contract rather than the amount allocated to a performance obligation.

If a construction contractor's process for estimating variable consideration already considers the underlying principles on which the variable consideration constraint guidance was based, then effectively the constraint has been evaluated concurrently with estimating the variable consideration amount and the contractor does not have to evaluate the constraint separately.

Factors (depending on their likelihood and magnitude) to consider when applying the variable consideration constraint and assessing whether it is probable that a significant reversal of cumulative revenue recognized will not occur include, but are not limited to:

- *To what extent is the amount of consideration influenced by factors not within the construction contractor's control?* The greater the extent to which the amount of consideration is determined by third parties (e.g., customer, regulator, supplier, subcontractor, arbitration judgments) and not within construction contractor's control, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the amount estimated should be constrained. Other factors to consider include volatility in the market, weather conditions and a high risk of obsolescence of the promised goods or services.
- *How much experience does the construction contractor have with similar customers?* The less experience the construction contractor has with similar types of projects, markets, contracts and variable consideration amounts (or predictive evidence thereto), the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained.
- *How uncertain is the construction contractor about when it will collect the variable amounts owed by its customers?* The longer it takes a construction contractor to resolve disputes, claims or unapproved change orders or earn variable fees, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained.
- *To what extent does the construction contractor offer a broad range of price concessions or change payment terms and conditions of similar contracts in similar circumstances?* The more the construction contractor changes the availability and amount of price concessions offered to its clients, the more likely it is that a significant reversal of cumulative revenue recognized could occur. The greater the degree of uncertainty that actual amounts will differ from expected amount, the more likely it is that the estimated amount should be constrained.
- *How broad is the range of possible consideration amounts?* The more volatile the range of possible consideration amounts, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained. This factor often is linked to an entity's experience and ability to accumulate historical data.

The analyses of many of these factors may change over time as a construction contractor gets more experience with the variable consideration guidance, and estimates of variable consideration should be updated each reporting period. The entity also should revise its measure of progress (e.g., estimated costs to complete the contract) as necessary as variable consideration estimates are updated.

Spotlight on change

Under ASC 605-35, variable consideration (e.g., an incentive payment) only is included in revenue recognized using the percentage-of-completion method when it is earned and realized or realizable. Making that determination under ASC 605-35 requires the exercise of significant judgment and the careful consideration of the relevant facts and circumstances. While the same is also important under ASC 606, the parameters for including variable consideration in the transaction price (which is the amount ultimately recognized as revenue) is unlike any guidance that exists in legacy GAAP, including ASC 605-35. As a result, construction contractors will need to change the processes they have in place to track and recognize variable consideration to ensure it is only included in the transaction price if it is probable that doing so will not result in a significant reversal of cumulative revenue recognized upon resolution of the related uncertainty.

C.3.2.3 Unpriced change orders and claims

A construction contractor should evaluate as variable consideration an unpriced change order (a change order in which the work to be performed is defined, but the contract price adjustment has yet to be determined), provided the change order is enforceable. If enforceable, the change order should be accounted for as a contract modification (separate guidance is provided for price and scope modifications that constitute a new contract [including those that constitute termination of the original contract] and those that change an existing contract [see Section C.1.4]), and the change in the transaction price resulting from the change order should be estimated under the variable consideration guidance.

Change orders in which both scope and price are unapproved or in dispute are considered claims. Claims normally are made for amounts in excess of the approved contract price that a contractor seeks to collect from customers or others. Construction contractors should evaluate a claim to determine whether it represents an enforceable obligation (see Section C.1.4 on contract modification) to be evaluated as variable consideration. If a claim is considered an enforceable obligation, construction contractors must apply the variable consideration guidance and should not assume that all of the variable consideration must be constrained and not included within the transaction price.

Spotlight on change

When the percentage-of-completion method is applied, ASC 605-35 approaches the accounting for unpriced change orders for which the scope has been approved, but the pricing has not yet been approved, by assessing whether costs of the change order are probable of being recovered through a change in the contract price. If recoverability is probable and the change in the contract price can be reliably estimated, the contract price is adjusted for an amount equal to the costs of the change order when those costs are recognized as costs of contract performance. Revenue exceeding the costs of the change order is not recognized unless realization is assured beyond a reasonable doubt. When both the scope and price of an unpriced change order have not been approved, ASC 605-35 requires it be accounted for as a claim.

Under ASC 606, an unpriced change order is a contract modification. If the scope of the unpriced change order has been approved, but the price has not been approved, the construction contractor would apply the variable consideration guidance to determine the transaction price for the modified contract and then determine whether the change order (i.e., the modification) should be accounted for: (a) as a separate contract, (b) prospectively, as if the original contract was terminated and new contract was entered into or (c) using a cumulative catch-up adjustment. Unlike the unpriced change order guidance in ASC 605-35, neither the variable consideration nor the contract modification guidance in ASC 606 considers the costs of the change order when accounting for the change order. Instead, the construction contractor estimates the amount to which it expects to be entitled in connection with the unpriced change order using either the expected value method or most likely amount method and then determines whether it is probable that including that estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized upon finalizing the pricing of the change order. When both the scope and price of an unpriced change order have not been approved, ASC 606 does not change the accounting for the contract until all necessary approvals have been obtained.

Construction contractors will need to change their financial reporting processes and internal controls related to accounting for unpriced change orders, given the vastly different models applied to these orders under ASC 606 and ASC 605-35. These vastly different models also will likely result in different amounts of revenue being recognized in a particular reporting period under ASC 606 compared to what would have been recognized under ASC 605-35.

Example 7: Identifying variable consideration in an unpriced change order

Developer B has entered into a contract, priced on a per feet/yard/mile basis, with Contractor A to re-pave a 20-mile stretch of highway. In the middle of the contract while both parties are on site, the state engineer authorizes the tear-up and repaving of an additional 10 miles on comparable terrain. Developer B and Contractor A agree on the additional 10-mile scope. The change order likely constitutes variable consideration to be estimated and included in the transaction price because the scope of it was agreed to by both parties, who are authorized to approve the final change order, and therefore it is considered enforceable. In estimating the variable consideration to be included in the transaction price, the initial contract's per-mile pricing likely would be used.

C.3.2.4 Incentives and penalties

Target incentives and penalties often cause changes to a contract's price, the amount of which is dependent on variables (completion date, plan capacity, actual costs) that are generally not known until contract end. Incentives can be cost- or performance-based. As noted in paragraph 11.3.06 of the Revenue Recognition AAG, substantial judgment and experience may be needed in determining whether results of performance will meet the targeted objectives. As a result, performance incentives should not automatically be included in the transaction price but instead should be evaluated as variable consideration to determine the amount to include with the transaction price.

Depending on the particular situation, including incentives and award fees in the transaction price may be most representative of the total consideration to which the entity expects to be entitled. Several illustrative examples are included in paragraph 11.3.13 of the Revenue Recognition AAG. In one of the examples, an engineering and construction entity estimates it will earn an award fee based directly on delivery by a certain date because, among other reasons, the contract is not complex and the entity has a history of meeting similar timelines. The entity determines that including the award fee in the transaction price is appropriate using the most likely consideration amount (determined by applying the variable consideration guidance). In another example where the outcome is highly subjective, significant judgment will be needed to determine the proper variable consideration estimation method and amount (e.g., estimating liquidated damages based on the number of days past an agreed-upon completion date). Each construction contractor should determine, based on its specific facts and circumstances, the appropriate method for estimating variable consideration.

A construction contractor is required to update its estimates of incentives and penalties on an ongoing basis, even if the beginning estimate is zero.

C.3.3 Significant financing component

When a contract includes a significant implicit or explicit benefit of financing to either the entity or the customer (i.e., a significant financing component), that significant financing component is taken into consideration in determining the transaction price, unless the entity qualifies for and elects to apply a practical expedient. A significant financing component could exist with respect to deferred or advance payment terms, which means it could result in the entity recognizing interest income or expense.

All of the relevant facts and circumstances related to the customer contract should be considered in determining whether it includes a significant financing component. For example, an entity should consider whether there is a difference between the amount the customer would have had to (i.e., hypothetically) pay for the goods or services in cash upon their transfer and the amount the customer is paying for those goods or services based on the payment terms in the contract. An entity also should consider the amount of time that will pass between when control of the promised goods or services is transferred to the customer and when customer payment is supposed to occur – along with relevant interest rates.

The new guidance specifically indicates that a significant financing component does *not* exist in any of the following situations:

- The customer makes an advance payment and when the promised goods or services are transferred to the customer is at the customer's discretion.
- There is substantial variable consideration, and payment of that consideration is contingent on the resolution of an uncertainty that is not substantially in the entity's or customer's control.
- There are reasons not related to financing that justify the nature and amount of the difference between the cash selling price of the promised goods or services and promised consideration. For example, deferred payment terms or contract holdbacks may protect the customer if the entity fails to satisfy some or all of its contractual obligations.

If a customer contract has a significant financing component, a practical expedient to ignore that financing component when estimating the transaction price can be applied if the entity expects the difference between the following two events to be one year or less at contract inception: (a) the entity's transfer of the promised goods or services to the customer and (b) customer payment for those goods or services. When assessing whether the practical expedient can be applied, it is important to focus on these two events and not the duration of the contract in its totality.

If an entity identifies a significant financing component in a customer contract, it must be taken into consideration in determining the transaction price unless the significant financing component qualifies for the practical expedient and the entity elects the practical expedient. The objective of doing so is to recognize revenue in an amount consistent with what the customer would have paid in cash upon the transfer of the promised good or service. To adjust the promised consideration for the significant financing component, the entity should use a discount rate consistent with the rate that would be present in a separate financing transaction between the entity and the customer at contract inception. Such discount rate should take into consideration: (a) the credit risk of the entity (when advance payments are involved) or the customer (when deferred payments are involved) and (b) any collateral or other security provided by either party (which could be the assets subject to the contract). The discount rate is not adjusted after contract inception.

Spotlight on change

ASC 605-35 does not explicitly address whether, and if so how, the time value of money should be reflected in the recognition of revenue by construction contractors. Under other legacy GAAP, receivables for which the payment is not due for more than one year generally are discounted. However, the same is not true for advance payments, which ASC 606 requires to be accounted for as a significant financing component under certain circumstances. This could represent a significant change for construction contractors that regularly receive long-term advance payments from their customers if those payments represent a significant financing component under ASC 606.

Example 8: Determining whether holdbacks from milestone payments that coincide with the entity's performance give rise to a significant financing component

The following example is *Example 27—Withheld Payments on a Long-Term Contract* from ASC 606-10-55-233 to 55-234:

> An entity enters into a contract for the construction of a building that includes scheduled milestone payments for the performance by the entity throughout the contract term of three years. The performance obligation will be satisfied over time, and the milestone payments are scheduled to coincide with the entity's expected performance. The contract provides that a specified percentage of each milestone payment is to be withheld (that is, retained) by the customer throughout the arrangement and paid to the entity only when the building is complete.
>
> The entity concludes that the contract does not include a significant financing component. The milestone payments coincide with the entity's performance, and the contract requires amounts to be retained for reasons other than the provision of finance in accordance with paragraph 606-10-32-17(c). The withholding of a specified percentage of each milestone payment is intended to protect the customer from the contractor failing to adequately complete its obligations under the contract.

C.4 Allocate the transaction price to the performance obligations

If a customer contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a customer contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception.

The standalone selling price of a performance obligation is the amount the entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the entity is required to estimate a standalone selling price. In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the entity, the market, the customer and the customer class. In addition, an entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

C.5 Recognize revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it. To properly assess when revenue should be recognized, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time.

Control of an asset has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, which includes being able to stop others from directing the use of the asset and receiving substantially all of the related remaining benefits.

For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain or save (directly or indirectly) as a result of having control of the asset.

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer. When present, the following indicators may signal that the customer has the ability to direct the use of the asset (and restrict others' use of the asset) and receive substantially all of the asset's remaining benefits:

- The customer is presently obligated to pay the entity for the transferred asset.
- The customer has legal title to the transferred asset.
- The customer has physical possession of the transferred asset.
- The customer has the significant risks and rewards of owning the asset.
- The customer has accepted the asset.

For purposes of determining whether the significant risks and rewards of owning the asset have transferred to the customer, the entity should only consider the risks associated with owning the asset included in the performance obligation for which control transfer is being evaluated (e.g., one building unit) and not the risks associated with owning the asset(s) included in other performance obligations in the contract for which control transfer will be separately evaluated (e.g., building maintenance after the construction period).

C.5.1 Determine whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the entity's performance at the same time as: (a) the customer receives those benefits and (b) the entity performs and creates those benefits. In some situations, it will be readily apparent that the customer is simultaneously receiving and consuming the benefits as the entity performs, such as in certain service arrangements. Situations in which the entity's performance results in the creation or enhancement of an asset do not also result in the benefits of the entity's performance being simultaneously received and consumed by the customer. For those situations in which the entity's performance creates or enhances an asset, the entity should consider whether one of the other two criteria are met.

  If it is not readily apparent whether this criterion is met for a particular set of facts and circumstances, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity.

- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance. An entity will need to carefully consider the indicators of control discussed previously in Section C.5 in assessing whether control of the asset passes to the customer as the entity performs. An example of a performance obligation that might meet this criterion, depending on all the facts and circumstances, is a construction contract in which the entity is building a manufacturing facility on land owned by the customer

- *No alternative use and an enforceable right to payment.* A performance obligation is satisfied over time if: (a) the asset created by the entity's performance does not have an alternative use to the entity upon its completion and (b) the entity's right to payment for its performance to date is enforceable.

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time the customer obtains control over the underlying good or service. The same criteria are evaluated regardless of whether the performance obligation includes one or more promised goods or services. In addition, these criteria include no predispositions that will result in a performance obligation that includes a promised good being satisfied at a point in time or a performance obligation that includes a promised service being satisfied over time. Each performance obligation should be evaluated against these indicators to determine whether revenue should be recognized over time or at a point in time.

If the performance obligation is considered satisfied over time, the related revenue is recognized over time if the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. In the unlikely scenario that an entity is unable to reasonably measure the outcome of a performance obligation, it should recognize revenue to the extent of the costs incurred to satisfy the performance obligation, but only if it expects to recover those costs. This approach is expected to be used only rarely and only until the entity is able to reasonably measure the outcome of a performance obligation.

In situations in which the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation, it must identify a single method by which to make that measurement. The objective of this method should be to measure the progress made in transferring control of the underlying goods or services to the customer. The method selected should be applied consistently to similar performance obligations in similar circumstances.

C.5.1.1 No alternative use

In performing the assessment as to whether the asset has an alternative use to the entity, an entity needs to determine the nature and substance of any legal, contractual or practical limitations on its ability to redirect (e.g., sell to another customer) the completed asset created by its performance. The asset does not have an alternative future use to the entity if the entity is either contractually restricted or practically limited from directing the asset for another use. For this purpose:

- *Contractual restriction.* A contractual restriction must be substantive and enforceable. In other words, to conclude that the asset has no alternative use to the entity, the customer must be able to enforce its right to obtain the asset if the construction contractor tries to use it for another purpose. In addition, that right must be meaningful, which would not be the case if the asset in question is readily interchangeable with other assets that the construction contractor could use to satisfy its obligation to the customer, without putting it in breach of contract or causing it to incur significant incremental costs.
- *Practical limitation.* If a practical limitation would result in an entity experiencing significant economic losses as a result of redirecting the asset for another use, the asset has no alternative use to the entity. Examples of situations in which a construction contractor could experience significant economic losses when trying to redirect the asset for another use include: (a) incurring significant costs to rework an asset because it was built to the original customer's specifications and (b) selling the asset for a significant loss because it had to be moved from the remote area in which it was built as specifically requested by the original customer.

In addition, the entity does not consider the possibility that the customer contract could be terminated when assessing whether it could redirect the asset for another use.

Example 9: Determining whether a satellite has an alternative use to the entity

The following example is *Example 15—Asset Has No Alternative Use to the Entity* from ASC 606-10-55-165 to 55-168:

> An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.
>
> At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.
>
> As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.
>
> For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

C.5.1.2 Enforceable right to payment

In performing the assessment as to whether an enforceable right to payment for performance to date exists, the entity must be able to conclude, based on the terms of the contract and applicable laws, that it is entitled to proportionate compensation for its performance to date at all times during the contract if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as promised. For this purpose: (a) an entity is not necessarily required to conclude that it has a present unconditional right to payment and (b) the amount to which the entity is entitled does not have to be a fixed amount.

To draw an appropriate conclusion as to whether the entity has an enforceable right to payment (by either demanding payment or retaining payment) for its performance completed to date if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as promised, a construction contractor should ensure it has a complete understanding of all the relevant facts and circumstances. Further, it is not just a matter of the entity having an enforceable right to payment for its performance completed to date. The payment itself must represent proportionate compensation for the entity's performance. Proportionate compensation would be an amount roughly equivalent to what the selling price would be for what the entity has completed to date. ASC 606-10-55-11 indicates the following:

> An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:
>
> a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)

b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

If a performance obligation is part of a contract priced at a loss, the entity has an enforceable right to payment for its performance to date if it is entitled to a proportionate amount of the performance obligation's selling price.

Spotlight on change

Under ASC 605-35, a construction contractor determines which of the following methods it should use to recognize revenue for a particular contract: (a) the percentage-of-completion method (which results in recognizing revenue over time as it performs under the contract) or (b) the completed-contract method (which results in recognizing revenue when the contract is complete or substantially complete). A key part of that determination is whether the construction contractor can make reasonably dependable estimates of its progress, revenue and costs under the contract. If the construction contractor can make such estimates, it would use the percentage-of-completion method to recognize revenue in most such situations. If the construction contractor cannot make such estimates, it would use the completed-contract method to recognize revenue in most such situations. However, in situations in which a construction contractor cannot make reasonably dependable estimates of revenue and costs under the contract, but there is assurance that the construction contractor will not incur a loss on the contract (e.g., there is a contract provision to that effect), the percentage-of-completion method is applied to recognize revenue, but on a zero-profit basis (i.e., revenue is recognized to the extent of costs incurred).

Under ASC 606, whether revenue is recognized over time or at a point in time depends on whether one or more of three specific criteria are met. None of these criteria are focused on whether the construction contractor can make reasonably dependable estimates of its progress, revenue or costs under the contract. In addition, under ASC 606, revenue is only recognized to the extent of costs incurred in limited circumstances, such as: (a) when the uninstalled materials in a performance obligation for which revenue is recognized over time using a cost-to-cost method to measure progress toward completion, provided certain criteria are met, and (b) when the entity recognizes revenue over time under ASC 606, but is unable to reasonably measure the outcome of a performance obligation, provided it expects to recover the costs.

Given the significant differences in how a construction contractor determines whether it should recognize revenue over time or at a point in time under ASC 606 compared to ASC 605-35, it is possible that a construction contractor recognizing revenue based on the percentage complete under ASC 605-35 may have to change to recognizing revenue at a point in time under ASC 606. Construction contractors will need to change their financial reporting processes and internal controls to ensure that the three criteria for recognizing revenue over time are appropriately evaluated with respect to each contract.

In applying ASC 605-35, construction contractors have the option of computing income earned over time under the percentage-of-completion method, using one of the following two alternatives:

- Alternative A, which generally results in recognizing revenue based on the percentage complete and contract costs as they are incurred
- Alternative B, which generally results in recognizing revenue and contract costs based on the percentage complete (i.e., recognizing revenue equal to costs incurred during the period plus the gross margin for the percentage complete).

While neither of these alternatives are explicitly provided for in ASC 606, the first alternative is fairly consistent with recognizing revenue over time under ASC 606. However, the second alternative would not be appropriate under ASC 606.

Example 10: Determining whether an enforceable right to payment for performance completed to date exists when there is a payment schedule

The following example is *Example 16—Enforceable Right to Payment for Performance Completed to Date* from ASC 606-10-55-169 to 55-172:

> An entity enters into a contract with a customer to build an item of equipment. The payment schedule in the contract specifies that the customer must make an advance payment at contract inception of 10 percent of the contract price, regular payments throughout the construction period (amounting to 50 percent of the contract price), and a final payment of 40 percent of the contract price after construction is completed and the equipment has passed the prescribed performance tests. The payments are nonrefundable unless the entity fails to perform as promised. If the customer terminates the contract, the entity is entitled only to retain any progress payments received from the customer. The entity has no further rights to compensation from the customer.
>
> At contract inception, the entity assesses whether its performance obligation to build the equipment is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.
>
> As part of that assessment, the entity considers whether it has an enforceable right to payment for performance completed to date in accordance with paragraphs 606-10-25-27(c), 606-10-25-29, and 606-10-55-11 through 55-15 if the customer were to terminate the contract for reasons other than the entity's failure to perform as promised. Even though the payments made by the customer are nonrefundable, the cumulative amount of those payments is not expected, at all times throughout the contract, to at least correspond to the amount that would be necessary to compensate the entity for performance completed to date. This is because at various times during construction the cumulative amount of consideration paid by the customer might be less than the selling price of the partially completed item of equipment at that time. Consequently, the entity does not have a right to payment for performance completed to date.
>
> Because the entity does not have a right to payment for performance completed to date, the entity's performance obligation is not satisfied over time in accordance with paragraph 606-10-25-27(c). Accordingly, the entity does not need to assess whether the equipment would have an alternative use to the entity. The entity also concludes that it does not meet the criteria in paragraph 606-10-25-27(a) or (b), and, thus, the entity accounts for the construction of the equipment as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Example 11: Determining whether a performance obligation made up of the sale of a unit in a multi-unit residential complex is satisfied over time or at a point in time

The following example is *Example 17—Assessing Whether a Performance Obligation Is Satisfied at a Point in Time or Over Time* from ASC 606-10-55-173 to 55-182:

> An entity is developing a multi-unit residential complex. A customer enters into a binding sales contract with the entity for a specified unit that is under construction. Each unit has a similar floor plan and is of a similar size, but other attributes of the units are different (for example, the location of the unit within the complex).
>
> **Case A—Entity Does Not Have an Enforceable Right to Payment for Performance Completed to Date**
>
> The customer pays a deposit upon entering into the contract, and the deposit is refundable only if the entity fails to complete construction of the unit in accordance with the contract. The remainder of

the contract price is payable on completion of the contract when the customer obtains physical possession of the unit. If the customer defaults on the contract before completion of the unit, the entity only has the right to retain the deposit.

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that it does not have an enforceable right to payment for performance completed to date because until construction of the unit is complete, the entity only has a right to the deposit paid by the customer. Because the entity does not have a right to payment for work completed to date, the entity's performance obligation is not a performance obligation satisfied over time in accordance with paragraph 606-10-25-27(c). Instead, the entity accounts for the sale of the unit as a performance obligation satisfied at a point in time in accordance with paragraph 606-10-25-30.

Case B—Entity Has an Enforceable Right to Payment for Performance Completed to Date

The customer pays a nonrefundable deposit upon entering into the contract and will make progress payments during construction of the unit. The contract has substantive terms that preclude the entity from being able to direct the unit to another customer. In addition, the customer does not have the right to terminate the contract unless the entity fails to perform as promised. If the customer defaults on its obligations by failing to make the promised progress payments as and when they are due, the entity would have a right to all of the consideration promised in the contract if it completes the construction of the unit. The courts have previously upheld similar rights that entitle developers to require the customer to perform, subject to the entity meeting its obligations under the contract.

At contract inception, the entity applies paragraph 606-10-25-27(c) to determine whether its promise to construct and transfer the unit to the customer is a performance obligation satisfied over time. The entity determines that the asset (unit) created by the entity's performance does not have an alternative use to the entity because the contract precludes the entity from transferring the specified unit to another customer. The entity does not consider the possibility of a contract termination in assessing whether the entity is able to direct the asset to another customer.

The entity also has a right to payment for performance completed to date in accordance with paragraphs 606-10-25-29 and 606-10-55-11 through 55-15. This is because if the customer were to default on its obligations, the entity would have an enforceable right to all of the consideration promised under the contract if it continues to perform as promised.

Therefore, the terms of the contract and the practices in the legal jurisdiction indicate that there is a right to payment for performance completed to date. Consequently, the criteria in paragraph 606-10-25-27(c) are met, and the entity has a performance obligation that it satisfies over time. To recognize revenue for that performance obligation satisfied over time, the entity measures its progress toward complete satisfaction of its performance obligation in accordance with paragraphs 606-10-25-31 through 25-37 and 606-10-55-16 through 55-21.

In the construction of a multi-unit residential complex, the entity may have many contracts with individual customers for the construction of individual units within the complex. The entity would account for each contract separately. However, depending on the nature of the construction, the entity's performance in undertaking the initial construction works (that is, the foundation and the basic structure), as well as the construction of common areas, may need to be reflected when measuring its progress toward complete satisfaction of its performance obligations in each contract.

Case C—Entity Has an Enforceable Right to Payment for Performance Completed to Date

The same facts as in Case B apply to Case C, except that in the event of a default by the customer, either the entity can require the customer to perform as required under the contract or the entity can cancel the contract in exchange for the asset under construction and an entitlement to a penalty of a proportion of the contract price.

Notwithstanding that the entity could cancel the contract (in which case the customer's obligation to the entity would be limited to transferring control of the partially completed asset to the entity and

> paying the penalty prescribed), the entity has a right to payment for performance completed to date because the entity also could choose to enforce its rights to full payment under the contract. The fact that the entity may choose to cancel the contract in the event the customer defaults on its obligations would not affect that assessment (see paragraph 606-10-55-13), provided that the entity's rights to require the customer to continue to perform as required under the contract (that is, pay the promised consideration) are enforceable.

RSM commentary: In Case A, only one of the three factors related to whether revenue should be recognized over time or at a point in time is addressed. The other two factors (ASC 606-10-25-27[a] and 25-27[b]) are not met in this example, because: (a) the customer is not consuming the entity's construction of the unit as the entity is building the unit and (b) the customer does not control the output of the construction services (i.e., the unit) until it obtains ownership of the unit at or near the end of the construction process.

In Cases B and C, it is important to note that the conclusion that the entity has an enforceable right to payment for performance completed to date hinges on the entity having the right to compel the customer to perform in the event of customer default, not on whether the entity would expect to exercise that right.

C.5.1.3 Recognizing revenue for performance obligations satisfied over time

If the performance obligation is considered satisfied over time, the related revenue is recognized over time if the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. In the unlikely scenario that an entity is unable to reasonably measure the outcome of a performance obligation, it should recognize revenue to the extent of the costs incurred to satisfy the performance obligation, but only if it expects to recover those costs. This approach is expected to be used only rarely and only until the entity is able to reasonably measure the outcome of a performance obligation.

In situations in which the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation, it must identify a single method by which to make that measurement. Output methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Regardless of which is used, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the underlying goods or services for which control has transferred to the customer and should not reflect any underlying goods or services for which control has not transferred to the customer. In addition, once a method is selected, it should be consistently applied to similar performance obligations in similar circumstances. To determine the method that best depicts progress toward complete satisfaction of a performance obligation, contractors should consider matters such as the nature of goods and services, specific contract terms such as contract termination rights and ability to demand or retain payments, and which party has title to the work in process.

Progress toward completion is calculated at the end of each reporting period and used in determining the appropriate amount of revenue to recognize in that period. The calculation is based on the amount of outputs or inputs to date and the estimated total amount of outputs or inputs necessary to satisfy the performance obligation. Prior to measuring progress toward completion at the end of a reporting period, the entity should consider whether the estimated total amount of outputs or inputs necessary to satisfy the performance obligation should be updated. Any updates to the estimates not caused by a contract modification or certain other factors (e.g., significant unexpected inefficiencies experienced by the entity) should be accounted for as a change in estimate in accordance with ASC 250, "Accounting Changes and Error Corrections."

Output methods

Output methods rely on the value of underlying goods or services included in the performance obligation. Examples of output methods that may be appropriate to apply (depending on the facts and circumstances) include:

- Surveying or appraising the value of the results achieved and comparing that amount to the value of the results expected from satisfying the performance obligation.
- Determining the units produced or units delivered and comparing that amount to the total units included in the performance obligation that are expected to be produced or delivered.
- Comparing time elapsed in satisfying the performance obligation with the time period over which the performance obligation is satisfied.
- Identifying the milestones reached and comparing those milestones to all of the milestones that must be reached in connection with satisfying the performance obligation.

A particular output method should only be used if the measure of progress it produces is consistent with how control of the goods or services transfers to the customer. As a result, care should be exercised to ensure an output method reflects all of the goods or services in the performance obligation for which control has transferred to the customer (even those goods or services that are partially completed). For example, if an entity plans to use a units-produced or units-delivered method, it should ensure that there is no work in process inventory for which control has passed to the customer because such inventory would not be included in the measure of units produced or units delivered, by definition. As discussed in paragraph 11.5.08 of the Revenue Recognition AAG, for construction contracts that include a termination for convenience clause that gives a customer effective control over the goods produced and work in process, a units-delivered or units-produced output method would not be appropriate as it would ignore the work in process that belongs to the customer. Further, as discussed in paragraph 11.5.18 of the Revenue Recognition AAG, a units-delivered or units-produced output method also may not be appropriate for contracts to provide design and production services as equal value is not delivered to the customer with each unit. However, as noted in paragraph 11.5.20 of the Revenue Recognition AAG, a units of delivery method may be appropriate in certain production-only contracts for homogeneous products.

A practical expedient is provided that allows an entity to use an output method under which revenue is recognized for the amount the entity has a right to invoice the customer if its right to consideration from that customer directly corresponds to the value received by the customer from the entity's performance completed to date. For example, if the customer contract requires the entity to provide operations and maintenance services to a customer billed at a set rate for each hour of service regardless of the nature or timing of the services provided, the entity may be able to elect this practical expedient. As discussed in paragraph 11.5.13 of the Revenue Recognition AAG however, revenue recognition based on the right to invoice may not be appropriate for certain contracts, such as maintenance service contracts with a significant variable incentive provision paid by the customer infrequently.

While an output method that is appropriately identified and utilized would often provide the best theoretical measure of an entity's progress in satisfying a performance obligation, in many cases the outputs of a performance obligation are not directly observable. In addition, identifying the value of the outputs produced for a performance obligation that is only partially satisfied may not be feasible without the entity expending undue cost and effort. As a result, input methods are used more often in practice than output methods.

Input methods

Input methods rely on the efforts put forth by the entity to satisfy the performance obligation. For construction contractors, appropriate input methods typically include labor hours spent, costs incurred, time elapsed or machine hours used. When using an input method, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the inputs related to the underlying goods or services for which control transfers to the customer and should not reflect the inputs related to the underlying goods or services for which control has not transferred to the customer. As a result, an input method should not reflect inputs that relate to activities that are not themselves goods or services, such as setup activities.

If an entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate to recognize revenue on a straight-line basis, such as a time-based method. However, as noted in paragraph 11.5.14 of the Revenue Recognition AAG, use of the straight-line basis of revenue recognition is expected to be limited for construction contractors as performance obligations generally are not satisfied evenly over the performance period.

In some situations, there might not be a direct relationship between the inputs expended by an entity and the amount of underlying goods or services for which control has transferred to the customer. In these situations, the entity must determine whether it can make adjustments to the input method to correct for the lack of a direct relationship or whether it should use a different input method or an output method. For example, if an entity is using a cost-to-cost method of measuring its progress toward the complete satisfaction of a performance obligation and incurs a cost that ultimately does not contribute to satisfying the performance obligation, the entity should remove that cost from both the numerator and denominator of the cost-to-cost measure. Common examples of costs in the engineering and construction industry that ultimately do not contribute to satisfying the performance obligation include those related to certain uninstalled materials, and significant inefficiencies such as unexpected wasted labor or materials (e.g., delays caused by third parties or the weather), among others. Determining which costs represent significant unexpected "wasted" materials, labor or other resources requires careful judgment, as construction contractors normally incur some unexpected inefficiencies that are reflected in contract pricing. In making this determination, an entity should ensure its course of action is consistent with the overall objective to measure the entity's performance in the contract and that it is consistent with other judgments it has made in similar situations. Making adjustments to a cost-to-cost measure when a cost incurred by the entity is not proportionate to its progress in satisfying the related performance obligation is discussed in Section C.5.1.4 on applying a cost-based input method when uninstalled materials exist.

Spotlight on change

The purpose of using an output or input method under ASC 605-35 is to measure the amount of revenue earned by a construction contractor in a particular reporting period. Under ASC 605-35, output measures are determined based on results achieved. Units produced or units delivered are output measures that may be used under ASC 605-35 when the construction contractor produces separate units of output for the customer.

The purpose of using an output or input method under ASC 606 is to measure the amount of promised goods or services for which control has transferred to the customer. While output measures also are determined based on results achieved under ASC 606, construction contractors need to exercise care in ensuring that the results achieved reflect the amount of the promised goods or services for which control has transferred to the customer. For example, if a construction contractor uses a units-produced or units-delivered output method under ASC 606, it should ensure that method takes into consideration any work in process at the beginning of the reporting period for which control transferred to the customer in the previous reporting period and any work in process at the end of the reporting period for which control transferred to the customer in the current reporting period. If the units-produced or units-delivered method does not appropriately consider work in process for which control has transferred to the customer at the end of a reporting period, it should not be used to measure the construction contractor's revenue.

Example 12: Applying a cost-to-cost input method or an output method to the construction of a hospital with a change in the estimate of total costs

Company A enters into a contract with Customer B on September 1, 20X1 to build a new hospital for $100 million. Company A expects construction of the hospital to take approximately three years, and it estimates it will incur construction costs totaling $85 million. The schedule by which Company A bills the $100 million transaction price is as follows:

Billing date	20X1	20X2	20X3	20X4
March 1	$ -	$7,000,000	$7,000,000	$7,000,000
June 1	-	7,000,000	7,000,000	7,000,000
September 1	7,000,000	7,000,000	7,000,000	16,000,000
December 1	7,000,000	7,000,000	7,000,000	-
Annual total	$14,000,000	$28,000,000	$28,000,000	$30,000,000
Contract total				$100,000,000

Customer B is obligated to pay the amounts billed by Company A within 60 days of the billing date.

Customer B already owns the land on which the hospital will be built. Based on its facts and circumstances, Company A concludes the contract includes a single performance obligation. Company A also concludes the contract is satisfied over time because control of the hospital transfers to Customer B as it is built by Company A.

Case 1: Cost-to-cost method

Company A decides it will use a cost-to-cost method to measure its progress toward completion of the hospital because:

- Company A has reliable information about the costs it expects to incur and the costs it actually incurs, which will enable it to reasonably measure its progress toward completion of the hospital.
- Company A concludes using a cost-to-cost method will measure its progress in transferring control of the hospital to Customer B because as Company A incurs costs to build the hospital, control of what is built with those costs transfers to Customer B.

In addition, Company A uses a cost-to-cost method to measure progress toward the complete satisfaction of other performance obligations similar to the one in its contract with Customer B.

As of December 31, 20X1 (its calendar year end), Company A has: (a) incurred construction costs of $8,500,000, (b) received the September 1 payment of $7 million from Customer B and (c) not yet received the December 1 payment of $7 million from Customer B. In addition, Company A continues to estimate that it will incur total costs of $85 million.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($8,500,000 construction costs incurred ÷ $85,000,000 total construction costs expected to be incurred)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million obligation to pay) and (b) Company A's performance ($10 million).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

During the first quarter of 20X2, Company A increases its estimate of total construction costs by $3 million, which consists of:

- $2 million of additional materials costs due to an unanticipated increase in certain construction materials.
- $1 million of foundation rework resulting from subpar workmanship on Company A's part.

As a result, Company A estimates its total construction costs to be $88 million. Company A has not yet decided whether it will seek a contract modification from Customer B to increase its fee for building the hospital to cover these costs. As of March 31, 20X2, Company A has: (a) incurred total construction costs to date of $16,660,000 (which includes the $1 million foundation rework costs), (b) received the December 1, 20X1 payment of $7 million from Customer B and (c) not yet received the March 1, 20X2 payment of $7 million from Customer B.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	8,160,000	
Contract liability (Note 2)	1,000,000	
Revenue (Note 3)		$8,000,000
Accounts payable (Note 4)		8,160,000

Note 1: $16,660,000 total construction costs incurred – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $3 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Company A's performance of $18 million ($10 million of revenue recognized in 20X1 + $8 million of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $1 million.

Note 3: ($100,000,000 transaction price × [($16,660,000 total construction costs incurred – $1,000,000 for foundation rework) ÷ ($88 million total construction costs expected to be incurred – $1,000,000 for foundation rework)]) – $10,000,000 recognized as revenue in prior periods. The foundation rework costs are eliminated from the cost-to-cost measure of progress toward complete satisfaction of the performance obligation because they are duplicative costs that do not incrementally contribute to satisfying the performance obligation.

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8,160,000 of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

Case 2: Output method

Customer B issued bonds to pay for the hospital being built by Company A. The bond covenants require Customer B to obtain an appraisal of the work performed by Company A as of each quarter end, starting with December 31, 20X1. Customer B's contract with Company A requires it to share those appraisals upon receipt from the appraiser. As a result, Company A decides to use the appraisals to measure its progress toward complete satisfaction of the performance obligation. Company A concludes using an output method based on appraised value will measure its progress in transferring control of the hospital to Customer B because as Company A performs and increases the value of the hospital, control of the hospital (and underlying value) transfers to Customer B.

The costs incurred and payments received as of December 31, 20X1 are the same as Case 1. In addition, the appraisal obtained by Customer B as of December 31, 20X1 indicates the value of the hospital is expected to be $100 million upon completion, and the value of the construction in process is $10 million.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($10,000,000 appraised value of the construction in process at December 31, 20X1 ÷ $100,000,000 appraised expected value of hospital upon completion)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million) and (b) Company A's performance ($10 million).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

The costs incurred and payments received as of March 31, 20X2 are the same as Case 1. In addition, the appraisal obtained by Customer B as of March 31, 20X2 indicates the value of the hospital is expected to be $102 million upon completion and the value of the construction in process is $18,360,000.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	8,160,000	
Contract liability (Note 2)	1,000,000	
Revenue (Note 3)		$8,000,000
Accounts payable (Note 4)		8,160,000

Note 1: $16,660,000 total construction costs incurred – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $3 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Company A's performance of $18 million ($10 million of revenue recognized in 20X1 + $8 million of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $1 million.

Note 3: ($100,000,000 transaction price × [$18,360,000 appraised value of the construction in process at March 31, 20X2 ÷ $102,000,000 appraised expected value of hospital upon completion) – $10,000,000 recognized as revenue in prior periods.

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the $8,160,000 of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

For ease of illustration, the percentages complete at December 31, 20X1 and March 31, 20X2 were the same as those in Case 1. While the expectation would be that the percentages complete under an input method and output method would be similar (all other things being equal) given that the objective of both is the same, the actual percentages complete may not necessarily be the same.

C.5.1.4 Applying a cost-based input method when uninstalled materials exist

In a typical construction project, goods procured from third parties generally are procured on an as-needed basis, preferably soon before integrating them into the project. These goods can range from standard items, such as steel, concrete or aluminum, to more customized items, such as piping configured in a unique manner for a particular project. In situations where significant materials arrive far in advance of installation, applying a cost-based input method that includes these costs could result in an entity overstating its progress toward satisfying the performance obligation, resulting in inappropriate earlier revenue recognition. A careful evaluation of the facts and circumstances is required for a construction contractor to evaluate whether it should exclude certain uninstalled materials from its input method and recognize revenue only to the extent of that cost incurred.

For an entity to reach a conclusion that it should exclude certain uninstalled materials from its input method, it must expect at contract inception that all of the following conditions will be met with respect to the uninstalled materials:

- The material 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. (In this situation, the entity is acting as a principal in accordance with ASC 606-10-55-36 through 606-10-55-40).

A construction contractor must first determine whether the procured materials are distinct. As noted in paragraph 11.5.32 of the Revenue Recognition AAG, this is not expected to be the case in a typical construction contract but nevertheless must still be evaluated. In situations where materials are not distinct and can be readily used by the contractor in fulfilling other construction projects without incurring significant modification costs, the inventoriable materials should be evaluated as an uninstalled material if the customer has obtained control and the remaining three conditions have been met.

If control of the materials has not yet transferred to the customer, these materials would not be considered uninstalled materials and may qualify as an inventoriable cost under ASC 330, “Inventory.” An entity will need to evaluate all facts and circumstances regarding delivery of goods as well as internal and external factors to determine whether control has transferred to the customer. For example, unexpected delays caused by weather, force majeure, technical challenges and the like could cause materials to arrive at the job site significantly in advance of the revised installation timing. In this example, the contractor may determine that the customer has not obtained control of the goods, even though the goods are physically at the job site, if goods can be used on other construction jobs and are inventoriable. This is because the goods consist of steel, concrete and copper wire that can be used for various construction contracts without incurring significant costs. In other situations, control may transfer when the item is installed, or prior to installation, if, for example, a security interest in the materials passes to the owner through billing of the specific materials procured. Evaluation of uninstalled materials should be performed throughout the contract's duration.

The second and third conditions indicate that if a customer is expected to obtain control of a good significantly before receiving the services related to that good (e.g., installing the goods in the project), those costs do not depict the entity's performance in satisfying the single performance obligation, provided the cost of the transferred good is significant relative to the total expected costs. In this situation if all other conditions are met, the costs should be excluded from the construction contractor's measure of progress when applying a cost-based input method until such time that the entity's performance is established.

The last condition indicates that if the contractor is significantly involved in the design and manufacture of an item, even if the item is procured from a third-party manufacturer, then procurement of the specifically designed materials would represent progress toward satisfying a performance obligation as it would not meet this condition to be considered an uninstalled material. An example of not meeting this condition would be an integrated construction contractor's design of materials fabricated by a third party, such as prefabricated walls of a nuclear power plant.

In situations where the construction contractor has determined that all four criteria are met and has recognized revenue in an amount equal to the good's cost, the entity should revisit the accounting upon installation of the good to determine whether the revenue recognized best depicts the entity's performance in the contract. As noted in paragraph 11.5.38 of the Revenue Recognition AAG, in certain situations, a construction contractor may conclude that including the costs in the cost-based input method as materials are installed would provide a more faithful depiction of progress toward satisfaction of the performance obligation. In other situations, a construction contractor may conclude that it is most appropriate to exclude the costs from the cost-based input method for the entire duration of the contract, because doing so would best depict the entity's performance under the contract.

Example 13: Determining whether a cost-based input method should be adjusted for uninstalled materials

The following example is *Example 19—Uninstalled Materials* from ASC 606-10-55-187 to 55-192:

> In November 20X2, an entity contracts with a customer to refurbish a 3-story building and install new elevators for total consideration of $5 million. The promised refurbishment service, including the installation of elevators, is a single performance obligation satisfied over time. Total expected costs are $4 million, including $1.5 million for the elevators. The entity determines that it acts as a principal in accordance with paragraphs 606-10-55-36 through 55-40 because it obtains control of the elevators before they are transferred to the customer.
>
> A summary of the transaction price and expected costs is as follows:

Transaction price	$5,000,000
Expected costs:	
Elevators	1,500,000
Other costs	2,500,000
Total expected costs	$4,000,000

> The entity uses an input method based on costs incurred to measure its progress toward complete satisfaction of the performance obligation. 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 December 20X2, although the elevators will not be installed until June 20X3. 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. Consequently, in accordance with paragraph 606-10-55-21, the entity adjusts its measure of progress to exclude the costs to procure the elevators from the measure of costs incurred and from the transaction price. 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).

As of December 31, 20X2, the entity observes that:

a. Other costs incurred (excluding elevators) are $500,000.

b. Performance is 20% complete (that is, $500,000 ÷ $2,500,000).

Consequently, at December 31, 20X2, the entity recognizes the following:

Revenue	$2,200,000 [(a)]
Costs of goods sold	2,000,000 [(b)]
Profit	$200,000 [(b)]

(a) Revenue recognized is calculated as (20% × $3,500,000) + $1,500,000. ($3,500,000 is $5,000,000 transactions price – $1,500,000 costs of elevators.)
(b) Cost of goods sold is $500,000 of costs incurred + $1,500,000 costs of elevators.

Spotlight on change

In discussing application of a cost-to-cost method of measuring the percentage of a contract that is complete, ASC 605-35 discusses uninstalled materials in the context of materials that have been purchased or are at job sites, but that are not unique to the particular project. For these uninstalled materials, ASC 605-35 indicates they should be excluded from the costs incurred when measuring the percentage of the project that is complete. ASC 605-35 does not include a provision similar to the one in ASC 606 that results in the recognition of revenue to the extent of the costs of uninstalled materials when certain criteria are met. The new provision included in ASC 606 will require construction contractors to include steps and controls in their financial reporting process related to evaluating uninstalled materials to determine whether revenue should be recognized for those materials to the extent of their costs.

C.5.2 Loss provisions

Existing guidance in legacy GAAP primarily was retained for the recognition of loss provisions on contracts with customer-provided specifications for facility construction, the production of goods, or provision of related services. ASC 605-35-15-2(a) indicates that the scope of the guidance in ASC 605-35 related to recognizing loss provisions on a contract applies to the following types of contracts entered into by contractors:

> The performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph 605-35-15-3 for examples). Contracts covered by this Subtopic are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications. Specifications imposed on the buyer by a third party (for example, a government or

regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be buyer's specifications.

For these purposes: (a) a contractor may be a general or prime contractor, a subcontractor or a construction manager and (b) a contract is a binding agreement between the contractor and its customer under which the contractor will provide a service to the customer's specifications.

The following table includes two lists of contracts that are examples of when the loss provision guidance in ASC 605-35 does and does not apply (neither list is all inclusive):

Examples of contracts to which the loss provision guidance in ASC 605-35…	
Does apply	**Does not apply**
From ASC 605-35-15-3: a. Contracts in the construction industry, such as those of general building, heavy earth moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, this Subtopic also would be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant. b. Contracts to design and build ships and transport vessels. c. Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts. d. Contracts for construction consulting service, such as under agency contracts or construction management agreements. e. Contracts for services performed by architects, engineers, or architectural or engineering design firms. f. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software.	From ASC 605-35-15-6: a. Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with generally accepted principles of inventory costing. b. Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time. c. Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts. d. Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period. e. Magazine subscriptions. f. Contracts of not-for-profit entities (NFPs) to provide benefits to their members over a period of time in return for membership dues. g. Contracts for which other Topics in the Codification provide special methods of accounting, such as leases. h. Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, other types of cost-plus-fee contracts, or contracts

Examples of contracts to which the loss provision guidance in ASC 605-35…	
Does apply	**Does not apply**
	such as those for products or services customarily billed as shipped or rendered. i. Federal government contracts within the scope of that Topic. j. Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use entity resources that do not alone produce a tangible commodity or product as the principal intended result (for example, services, not plans, are usually the principal intended result in a transaction between an architect and the customer of an architect).

C.5.2.1 Recognition and measurement

A contractor may elect to recognize and measure loss provisions on contracts within the scope of ASC 605-35 at one of the following two levels:

- *Contract level (or combined contract level)*. The contract (or combined contracts) is the unit of account for which a loss provision is recognized and measured (when necessary). Combined contracts should only be the unit of account if the contracts were combined as a result of applying the contract combination guidance in ASC 606 (see Section C.1.3). If loss provisions are recognized and measured at this level, more than one performance obligation may be affected.
- *Performance obligation level*. The performance obligation is the unit of account for which a loss provision is recognized and measured (when necessary).

The same accounting policy must be applied to similar contracts.

If a contractor anticipates a loss on a particular unit of account, the entire anticipated loss should be recognized and measured by the contractor in the period the loss becomes evident. A loss provision is recognized and measured when the current estimate of contract costs exceeds the current estimate of consideration expected to be received. The entire loss is recognized in the period it becomes evident.

C.5.2.2 Current estimate of contract costs

The current estimate of contract costs should include all of the fulfillment costs allocable to a customer contract. For its cost-plus contracts, a contractor also should consider whether any nonreimbursable costs should be included in the current estimate of contract costs. For all its contracts, a contractor should consider whether there are any costs associated with change orders accounted for as contract modifications (see Section C.1.4.1) that should be included in the current estimate of contract costs. In addition, for purposes of determining its total cost overrun on a contract, the contractor should use its normal cost accounting methods.

C.5.2.3 Current estimate of consideration expected to be received

The current estimate of consideration expected to be received is determined in accordance with ASC 606 and depends on whether the unit of account for recognizing and measuring a loss provision is the:

- *Contract (or combined contracts)*. The current estimate of consideration expected to be received is the transaction price for the contract (or combined contracts) reduced by the amount the contractor does not expect to collect from the customer due to the customer's credit risk and increased by the effects of removing the variable consideration constraint (if any) (see Section C.3.2.2).
- *Performance obligation*. The contractor allocates the current estimate of consideration expected to be received for the contract (or combined contracts) to the performance obligations using the guidance in ASC 606 on allocating the transaction price to the performance obligations (see Section C.4), which results in the current estimate of consideration expected to be received for each performance obligation.

It would not be uncommon for a contractor to incur a performance penalty in a situation in which it expects to incur a loss on a particular unit of account. If the contractor recognizes a loss provision for a particular unit of account, it should include any related performance penalty. A contractor also should consider other forms of variable consideration (e.g., target rewards, potential price redeterminations) and whether there is any consideration associated with change orders accounted for as contract modifications (see Section C.1.4.1) that should be included in the current estimate of consideration expected to be received.

Example 14: Accounting for a loss provision on a construction contract

Contractor A enters into a contract with Customer B on September 1, 20X1 to build a new hospital for $100 million. Contractor A sets a completion date for the hospital of August 31, 20X4 and estimates that it will incur total construction costs of $85 million. The schedule by which Contractor A bills the $100 million transaction price is as follows:

Billing date	20X1	20X2	20X3	20X4
March 1	$ -	$7,000,000	$7,000,000	$7,000,000
June 1	-	7,000,000	7,000,000	7,000,000
September 1	7,000,000	7,000,000	7,000,000	16,000,000
December 1	7,000,000	7,000,000	7,000,000	-
Annual total	$14,000,000	$28,000,000	$28,000,000	$30,000,000
Contract total				$100,000,000

Customer B is obligated to pay the amounts billed by Contractor A within 60 days of the billing date. In addition, if Contractor A finishes construction of the hospital by May 31, 20X4 (which is three months ahead of its scheduled completion), Customer B will pay Contractor A an additional $8 million. Based on Contractor A's past success with finishing construction of similar hospitals earlier than the established completion date, Contractor A believes there is a better than 50 percent likelihood it will finish the hospital three months early and be entitled to the additional $8 million of consideration. Said differently, Contractor A's estimate of variable consideration using the most likely amount method is $8 million. However, in applying the variable consideration constraint, Contractor A does not believe it is probable that including the additional $8 million in the transaction price will not result in a significant reversal of cumulative revenue recognized upon resolution of the uncertainty related to when the hospital will be completed. As a result, Contractor A does not include the variable consideration of $8 million in the transaction price (i.e., the variable consideration of $8 million is constrained).

Customer B already owns the land on which the hospital will be built. Based on its facts and circumstances, Contractor A appropriately concludes: (a) the contract includes a single performance obligation, (b) the contract is satisfied over time because control of the hospital transfers to Customer B as it is built by Contractor A and (c) the cost-to-cost method will be used to measure its progress toward completion of the hospital.

December 31, 20X1

As of December 31, 20X1 (its calendar year end), Contractor A has: (a) incurred construction costs of $8,500,000, (b) received the September 1 payment of $7 million from Customer B and (c) not yet received the December 1 payment of $7 million from Customer B. In addition, Contractor A continues to estimate that it will incur total costs of $85 million. Contractor A also continues to reach the same conclusions with respect to finishing the hospital three months early and being entitled to the variable consideration, which results in the variable consideration continuing to be constrained.

The following journal entry illustrates the effects of Contractor A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	$7,000,000	
Accounts receivable	7,000,000	
Costs of construction	8,500,000	
Revenue (Note 1)		$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: $100,000,000 transaction price × ($8,500,000 construction costs incurred ÷ $85,000,000 total construction costs expected to be incurred)

Note 2: The contract liability represents the difference between: (a) Customer B's performance ($7 million payment) and obligation to perform ($7 million obligation to pay) and (b) Contractor A's performance ($10 million).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Contractor A incurred the $8.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

March 31, 20X2

Due to a natural disaster in the geographic location of Contractor A's primary supplier of construction materials, there has been a significant decrease in the availability of construction materials from this supplier. In addition, because of the damage to hospitals and other facilities in the geographic location affected by the natural disaster, there has been an increase in the demand for construction materials and experienced construction workers. This increase in demand and decrease in supply has caused Contractor A's estimate of the costs it expects to incur to complete the construction of the hospital to increase to $105 million. Contractor A has not yet determined whether it will be able to seek additional compensation from Customer B to help cover the increased costs of building the hospital.

As of March 31, 20X2, Contractor A has: (a) incurred total construction costs to date of $21 million, (b) received the December 1, 20X1 payment of $7 million from Customer B and (c) not yet received the March 1, 20X2 payment of $7 million from Customer B. Contractor A continues to apply the most likely amount method for purposes of estimating the amount of variable consideration to which it expects to be entitled. Despite the natural disaster, Contractor A continues to believe there is a greater than 50 percent likelihood that it will finish the hospital three months early because it plans to redirect certain resources from other construction projects to the construction of Customer B's hospital. However, due to the effects of the natural disaster, Contractor A is not able to conclude that it is not probable that including the $8 million in the transaction price will not result in a significant reversal of cumulative revenue recognized upon resolution of the uncertainty related to when the hospital will be completed.

As a result, Contractor A does not include the variable consideration of $8 million in the transaction price (i.e., the variable consideration of $8 million is constrained).

The following journal entry illustrates Contractor A's accounting for the revenue and costs related to its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	$7,000,000	
Costs of construction (Note 1)	12,500,000	
Contract liability (Note 2)	3,000,000	
Revenue (Note 3)		$10,000,000
Accounts payable (Note 4)		12,500,000

Note 1: $21,000,000 total construction costs incurred to date – $8,500,000 construction costs incurred in prior periods

Note 2: The balance in the contract liability should be $1 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and (b) Contractor A's performance of $20 million ($10 million of revenue recognized in 20X1 + $10 million of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by $3 million.

Note 3: ($100,000,000 transaction price × [$21,000,000 total construction costs incurred to date ÷ $105,000,000 total construction costs expected to be incurred]) – $10,000,000 recognized as revenue in prior periods

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Contractor A incurred the $12.5 million of construction costs, including cash (e.g., payments for labor costs) and materials inventory.

Because of the increase in total expected construction costs, Contractor A performs the following analysis to determine whether it should recognize a loss provision related to its contract with Customer B:

Current estimate of consideration expected to be received:	
Transaction price for the contract	$100,000,000
Less the amount the entity does not expect to collect from the customer due to its credit risk (At March 31, 20X2, Contractor A believes it has no credit risk with respect to Customer B.)	-
Plus the effects of removing the variable consideration constraint	8,000,000
	108,000,000
Current estimate of contract costs	105,000,000
Estimated profit (loss) on the contract	$3,000,000

Based on this analysis and the facts provided, Contractor A should not recognize a loss provision.

Assume the facts were changed such that Contractor A was not able to redirect resources to the construction of Customer B's hospital, causing Contractor A to conclude there was no longer a greater than 50 percent likelihood that it will finish the hospital three months early. Based on that change in facts, the estimated amount of variable consideration to Contractor A would expect to be entitled would be zero *before* applying the variable consideration constraint. As a result, the variable consideration would not be added to the transaction price to arrive at the current estimate of consideration expected to be received for purposes of determining whether a loss provision should be recognized. Instead, the current estimate of consideration expected to be received would be $100 million, which would result in

Contractor A recognizing a loss provision of $5 million. Given the significant accounting consequences of concluding whether there is a greater than 50 percent likelihood of Contractor A finishing the hospital three months early, Contractor A should carefully consider all of the facts and circumstances in the context of the variable consideration guidance in ASC 606 and the loss provision guidance in ASC 605-35.

C.5.2.4 Presentation of loss provision

The loss provision for a unit of account should be presented as an additional contract cost on the income statement and should not be: (a) presented as a reduction of revenue or (b) classified as a separate line item on the income statement unless the amount of the loss is material or the nature of the loss is unusual or infrequent. In those limited situations in which the loss is classified as a separate line item on the income statement, it should still be included in the determination of gross profit.

To the extent a significant liability is recognized related to a loss provision, it should be separately presented on the balance sheet. However, if there are costs accumulated on the balance sheet related to the unit of account, a contractor may choose to recognize the loss provision for that unit of account as a reduction of the accumulated costs instead of recognizing it as a liability. When a separate liability is presented on the balance sheet for a loss provision, it should be classified as a current liability.

D. Contract costs

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under customer contracts within the scope of ASC 606 should be capitalized. The categories of costs addressed in ASC 340-40 include costs to fulfill a customer contract and incremental costs to obtain a customer contract.

D.1 Costs to fulfill a customer contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a customer contract within the scope of ASC 606, that other guidance should be applied. For example, costs to purchase goods beyond the requirements of an existing contract due to expected future orders likely would be evaluated under ASC 330. Costs to fulfill a customer contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or specific anticipated contract (e.g., design costs of an asset for a specific contract that is pending approval).
- The costs incurred by the entity generate or enhance resources the entity will use in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not a performance obligation in and of themselves but do contribute to the satisfaction of the performance obligations).
- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the customer contract and expected renewals will cover the costs).

For construction contractors, costs incurred directly related to a contract include direct labor and materials, costs incurred only because the entity entered into the contract (e.g., subcontracting costs), costs allocable to the contract or contract activities (e.g., costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract), and other costs explicitly chargeable to the customer under the contract.

Costs required to be expensed as incurred include general and administrative costs (unless explicitly chargeable or recoverable under the contract (e.g., contracts with the U.S. federal government through the provisions of the Federal Acquisition Regulations), costs related to satisfied or partially satisfied performance obligations (i.e., costs related to past performance), costs of wasted materials, labor or other resources to fulfill the contract that were not reflected in the contract price (refer to Section C.5.1.3), and costs that the entity cannot distinguish between unsatisfied, partially satisfied or satisfied performance obligations.

A construction contractor should carefully consider all facts and circumstances in determining which costs are “wasted.” For example, a situation in which incorrect materials are used and need to be replaced due to a construction error generally would result in immediate expense, presuming the materials could not be used elsewhere. In another situation, the cost of an engineer producing several drawings for the same contract likely would not constitute “wasted” labor because the efficiencies gained should benefit future contracts.

D.1.1 Precontract costs

Costs incurred for a specific anticipated contract (i.e., precontract costs) should be evaluated for capitalization under other authoritative literature before applying the guidance in ASC 340-40. Precontract costs not addressed under other authoritative literature are subject to the same capitalization criteria as contract fulfillment costs. Precontract costs of a construction contractor may consist of (a) engineering, design, mobilization or other services performed on the basis of commitments or other indicators of interest, (b) costs for the purchase of production equipment, materials and supplies relating to specific anticipated contracts, (c) costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of follow-on orders for the same item and (d) startup or mobilization costs incurred. The option does not exist to expense fulfillment costs meeting these criteria as it does for costs to obtain a contract.

Spotlight on change

In general, precontract costs that will not provide any future benefit unless the construction contractor obtains the contract are deferred under ASC 605-35 if they can be assigned (i.e., are directly related) to a specific anticipated contract and their recovery is probable. Examples of such costs include the costs of mobilization, engineering, architectural or other services incurred due to a customer’s interest in negotiating a contract.

ASC 340-40 provides guidance on when to capitalize costs to obtain a customer contract (which was discussed previously) and when to capitalize fulfillment costs. The circumstances under which both costs to obtain a customer contract and costs to fulfill a customer contract are capitalized under ASC 340-40 are different from one another and different from the circumstances under which the precontract costs related to obtaining or fulfilling a contract are deferred under ASC 605-35. Given these differences, construction contractors will need to carefully evaluate whether a cost they currently think of as a precontract cost is a cost to obtain a contract or a cost to fulfill a contract, and then apply the applicable guidance in ASC 340-40 to determine whether such cost should be capitalized.

D.1.2 Learning, start-up or mobilization costs

Learning and start-up costs usually consist of materials, labor, overhead, re-work or other costs incurred to complete an existing contract or contracts in progress. These costs generally are anticipated and considered in negotiating and establishing contract prices. Pre-construction mobilization costs include costs to move personnel, equipment and supplies to the project site to set-up temporary facilities for a construction project (such as offices, construction parking areas, access roads and utilities). Learning, start-up and mobilization costs related directly to a contract or an anticipated identified contract (that meet the additional two criteria under Section D.1 for capitalization) may be eligible for capitalization, provided they are not part of satisfying a performance obligation where control is continually transferred to the customer. As discussed in ECCRR Issue #4-6, “Contract Costs”, which is finalized but has not yet been included in the Revenue Recognition AAG, if mobilization or pre-construction fulfillment activities are required to satisfy a performance obligation and control is transferred to the customer over time, those costs should be recognized as incurred rather than capitalized. A construction contractor will need to evaluate its own facts and circumstances to determine whether pre-construction costs incurred are a necessary part of fulfilling a contract.

As discussed in paragraphs BC313 and BC314 of ASU 2014-09, if an entity has a single performance obligation to deliver a specified number of units and the performance obligation is satisfied over time, an entity might select a method (such as cost-to-cost) that results in the entity recognizing more revenue and expense for the early units produced relative to the later units. ECCRR Issue #4-6 provides an example in which the cost of constructing the bottom floors of a 10-story building are expected to cost more than the top floors because of the learning curve costs. Hence, the contractor will recognize more revenue and costs for the bottom floors than the latter floors.

D.2 Incremental costs to obtain a customer contract

The incremental costs to obtain a specific customer contract within the scope of ASC 606 are those costs that would not have been incurred if the customer contract was not obtained. The incremental costs to obtain a customer contract should be capitalized if the entity expects to recover these costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). Examples of incremental costs to obtain a contract for an engineering and construction firm include sales commissions and development fees paid relating to the construction for a public-private partnership, if incurred solely as a result of obtaining the contract and considered recoverable. However, an entity may elect a practical expedient that allows it to expense the incremental costs to obtain a customer contract if the amortization period for those costs would otherwise be one year or less. An entity is not allowed to defer costs simply for purposes of normalizing profit margins over the life of a contract.

The costs to obtain a customer contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the customer contract that would have been incurred even if the customer contract was not obtained. These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred. For example, costs such as salaries for employees working on a proposal likely would not be capitalized unless explicitly chargeable to the customer.

Spotlight on change

Under ASC 605-35, selling costs are deferred if they are directly related to a specific anticipated contract and their recovery is probable. Otherwise, such costs should be expensed as incurred. Under ASC 340-40, costs to obtain a contract only are capitalized if they are expected to be recovered and they are incremental to obtaining a contract. In other words, to be capitalized, the construction contractor must be able to conclude that the cost would not have been incurred if the customer contract had not been obtained. While a sales commission likely would be deferred or capitalized under both ASC 605-35 and ASC 340-40, the same cannot be said for many other types of selling costs. For example, while the direct costs of proposing on a specific project likely would be deferred under ASC 605-35 if they are probable of recovery, such costs would not be capitalized under ASC 340-40 because they are not incremental (i.e., they would be incurred regardless of whether a contract for the project is obtained).

D.3 Amortization and impairment of capitalized costs

The amortization method and period used to amortize capitalized costs related to obtaining or fulfilling a customer contract (including an anticipated contract, such as a contract renewal) should be systematic and consistent with how and when the related goods or services are transferred to the customer. For example, if the capitalized costs relate to a construction contract for which progress toward complete satisfaction of the performance obligation is measured using a cost-based input method, the costs should be amortized proportionately with the construction costs incurred.

To the extent there is a significant change in how and when the related goods or services are transferred to the customer, the entity should make a corresponding change to the amortization method and (or) period used to amortize any related capitalized costs. The entity should treat this change as a change in accounting estimate under ASC 250.

Entities should use judgment to determine the amortization period. Depending on the facts and circumstances, it may be appropriate for a construction contractor to use an amortization period longer than the initial contract period, such as periods related to contract renewals on a maintenance contract.

Costs capitalized in accordance with ASC 340-40 are tested for impairment by comparing the carrying amount of capitalized costs to an amount that considers all of the following: (a) the contract consideration an entity expects to receive in the future (b) the contract consideration the entity has already received but not yet recognized as revenue and (c) the direct costs related to transferring goods or services that remain to be recognized as an expense under the contract. For purposes of testing the capitalized costs for impairment, the time period reflected in the impairment test should take into consideration expected contract renewals and extensions with the same customer. An example given in ECCRR Issue #4-6 is one in which a contract termination occurs prior to amortization of the related costs. In this example, an impairment loss should be recognized unless the contractor expects to recover the costs as part of a termination settlement.

Before recognizing an impairment loss on costs capitalized in accordance with ASC 340-40, a construction contractor should first evaluate whether any impairment losses exist on certain other assets related to its customer contracts, such as inventory. In addition, an entity should recognize any necessary impairment loss on costs capitalized in accordance with ASC 340-40 before it tests and recognizes an impairment loss on other assets within the scope of ASC 340 (e.g., preproduction costs capitalized in accordance with the applicable guidance in ASC 340-10), ASC 360 (e.g., property, plant and equipment) or ASC 350 (e.g., goodwill).

Once an impairment loss is recognized, it cannot be reversed under any circumstances.

E. Balance sheet presentation

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between a construction contractor's performance (i.e., the goods or services transferred to the customer) and the customer's performance (i.e., the consideration paid by, or unconditionally due from, the customer). However, before recognizing a contract asset or liability, the entity must first consider whether an accounts receivable should be recognized.

As noted in paragraph 11.7.35 of the Revenue Recognition AAG, because the billing-to-performance relationship in long-term construction contracts is often complex, particularly with regard to work-in-progress subject to retentions, contracts with termination clauses, milestone payments that may not align with performance, and revisions in estimates, understanding the relationship between revenue and changes in contract balances is critical to users of the financial statements and related qualitative and quantitative information should be disclosed. Proper balance sheet presentation provides transparency about revenues and cash flows in relation to current-period performance.

E.1 Accounts receivable

When determining the amount of the contract asset or liability to be recognized (if any), an entity should first determine whether it has an unconditional right to any consideration from the customer. An unconditional right exists when only the passage of time is required before customer payment. If the entity has an unconditional right to consideration from the customer, it should recognize a receivable. This is the case even if the customer has a right of refund or the amount has not been billed.

For example, as noted in paragraph 11.7.33 of the Revenue Recognition AAG, unbilled work-in-process related to a construction contract with a termination clause giving the contractor the right to payment (including related gross profit) for work performed to date if the customer terminates the contract would likely be reclassified from a contract asset to unbilled receivables.

Once recognized, a receivable is accounted for in accordance with the accounts receivable guidance in the ASC 310, "Receivables," and ASC 326-20, "Financial Instruments – Credit Losses – Measured at Amortized Cost" (once effective).

E.2 Contract assets and liabilities

A contract asset arises if the construction contractor's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is greater than the consideration paid or recognized as a receivable). The recognition of a contract asset signals to users of the financial statements that the entity has transferred promised goods or services to the customer (and recognized revenue) for which the customer has neither paid nor become unconditionally obligated to pay. In other words, a contract asset represents the entity's conditional right to consideration for its performance.

A contract liability arises if the customer's performance is greater than that of the construction contractor (i.e., the consideration paid or recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer). The contract liability is recognized upon the earlier of the customer making a payment or becoming unconditionally obligated to make a payment that results in the customer's performance being greater than the entity's performance. The recognition of a contract liability signals to users of the financial statements that the entity's customer has paid for, or is unconditionally obligated to pay for, promised goods or services the entity is obligated to transfer to the customer, but has not yet transferred to the customer. For example, a customer's upfront payment resulting in the customer's performance exceeding that of the construction contractor would result in the entity recognizing a contract liability for its obligation to transfer goods or services under the contract.

Contract asset and *contract liability* are not required descriptors for the related asset or liability in the balance sheet. However, if a descriptor other than contract asset is used, it needs to clearly indicate that the asset represents something other than a receivable.

F. Disclosures

F.1 Disclosures required by ASC 606

The new guidance includes many new qualitative and quantitative disclosure requirements. While the most disclosures are required of public entities, many disclosures also are required of nonpublic entities. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenues and related cash flows. In general, construction contractors are required to disclose a variety of information about the contracts they have with customers and significant judgments used in applying the new guidance.

A construction contractor should review its systems, processes, procedures and internal controls to determine whether it is capable of providing the information necessary to satisfy the new disclosure requirements discussed in the remainder of this section, and if not, what changes it must make to enable it to provide the necessary information.

F.1.1 Disaggregated revenue

Public construction contractors are required to disclose a quantitative disaggregation of revenue based on how economic factors affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

Nonpublic construction contractors that do not elect to provide the quantitative disclosures required for public construction contractors should disaggregate revenue based on when control of the goods or services transfers to the customer (e.g., over time or at a point in time). In addition, such nonpublic construction contractors should provide qualitative discussion about how economic factors (such as those that might otherwise serve as the basis for quantitative disaggregation) affect the nature, amount, timing and uncertainty of revenue recognition and cash flows. As noted in paragraph 11.7.6 of the Revenue Recognition AAG, for many construction contractors it may be easier to prepare disclosures after disaggregating revenue, and therefore even for nonpublic construction contractors it may be beneficial to disaggregate revenue if sources of revenue are significantly different.

When determining the appropriate disaggregation levels and categories to use in financial statement disclosures, public construction contractors (and other construction contractors that elect to provide the disclosures required of public construction contractors) should consider how they present revenue for other purposes, such as to investors and members of management or governance committees. In considering the needs of financial statement users, a construction contractor will want to carefully evaluate all sources of revenue and the varying judgments used to recognize different types of revenue. Common categories of disaggregated revenue for construction contractors include: (a) type of good or service (e.g., by major product line), (b) geographic region, (c) contract and customer type (e.g., fixed-price and time-and-materials contracts, or residential and commercial contracts), (d) contract duration, (e) timing of transfer of goods or services (e.g., at a point in time or over time), or (f) market type (revenue from public sources [governments] and private sources), among others.

F.1.2 Contract balances

All construction contractors should disclose, or present separately on the face of the balance sheet, the opening and closing balances of accounts receivable, contract assets and contract liabilities.

Public construction contractors are also required to disclose the following, which are optional for nonpublic construction contractors:

- *The amount of revenue recognized in the current reporting period that was included in the contract liability balance at the end of the previous reporting period.* For example, if a construction contractor had a contract liability balance at the end of the previous reporting period due to it receiving upfront nonrefundable payments for which it had not yet fully performed, it should disclose the amount of that liability that was recognized as revenue in the current reporting period.
- *An explanation (which may be qualitative) of the timing of the construction contractor's satisfaction of its performance obligations compared to the timing of when it typically receives payment for providing the underlying goods or services and how the contract asset and contract liability balances are affected by this timing.*
- *A qualitative and quantitative explanation of what caused significant changes in the contract assets or contract liabilities during the reporting period.* For example, if a construction contractor acquires another construction contractor during the reporting period, it should explain the acquisition's effects on contract assets or contract liabilities.

A construction contractor's revision of estimates (e.g., variable consideration, percentage of completion), if any, should be evaluated for its impact on contract balances. If material, an entity should explain the effects on contract assets or contract liabilities of revising an estimate. This will provide relevant information about the timing of revenue recognition that was not a result of current period performance.

F.1.3 Performance obligations

A construction contractor is required to disclose the following about its performance obligations:

- *When its performance obligations are typically satisfied.* For example, a residential builder that constructs a home on a customer's land may disclose that its performance obligations are satisfied over time as it transfers control to the customer.
- *Significant payment terms*. For example, a construction contractor may disclose whether it charges advance fees and whether those fees are refundable.
- *Nature of the promised goods or services provided to customers*. For example, a construction contractor may disclose that it provides both residential and commercial services to local developers.
- *Obligations it has in its customer contracts related to rights of return or refund or other similar customer rights.* For example, a construction contractor may disclose the circumstances under which an advance fee is refundable.
- *Warranties and related obligations*. For example, a construction contractor may disclose standard warranty provisions of inspections or surveys.
- *Revenue recognized in the current reporting period related to performance obligations satisfied (or partially satisfied) in the prior reporting period.* For example, a construction contractor may disclose revenue recognized in the current reporting period related to services provided in a prior reporting period resulting from settlement adjustments that differed from the amount included in the transaction price based on the variable consideration guidance.

F.1.4 Transaction price allocated to remaining performance obligations

Remaining performance obligations are those performance obligations identified in a customer contract entered into before the end of a reporting period for which control of some or all of the underlying goods or services has not been transferred to the customer at the end of the reporting period. A remaining performance obligation may be a partially satisfied performance obligation or a completely unsatisfied performance obligation.

With certain exceptions, the following information about remaining performance obligations at the end of a reporting period should be disclosed by public construction contractors and may be disclosed by nonpublic construction contractors:

- *The total amount of the transaction price allocated to those performance obligations*.
- *An explanation of when the construction contractor expects to recognize the transaction price allocated to these performance obligations as revenue*. This disclosure requirement can be satisfied either quantitatively (using appropriate time bands for when the allocated transaction price is expected to be recognized as revenue) or qualitatively.

As described further in ASC 606-10-50-14 to 50-14B, there are two optional exemptions related to these remaining performance obligation disclosure requirements. An entity should disclose which of the optional exemptions it has elected to apply, as well as the following information about the related remaining performance obligations: (a) their nature, (b) their remaining duration and (c) a description of any variable consideration excluded from the disclosures as a result of electing one or both of the optional exemptions.

As noted in paragraph 11.7.17 of the Revenue Recognition AAG, construction contractors should consider including information about contingent performance obligations, if any, in its disclosure of when it expects to recognize as revenue the aggregate amount of its remaining performance obligations. Qualitative disclosures could include defining the events that result in the contingent performance obligation being included in the remaining performance obligations quantitative disclosure, and the related accounting policies and assumptions. To best meet the disclosure objectives, the construction contractor may need to describe the impact of various contractual terms (e.g., termination provisions, options, variable consideration) on its contracts.

F.1.5 Significant judgments

An engineering and construction entity should disclose judgments (and changes to those judgments) it makes in applying the new guidance that significantly affect when and how much revenue is recognized related to its customer contracts. The disclosures should include those judgments (and changes in judgments) involved in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied.

The following information should be disclosed by all construction contractors:

- *For performance obligations satisfied over time, the specific input or output method used to recognize revenue.*
- *In applying the variable consideration constraint, the judgments involved in identifying the methods, inputs and assumptions used.*

The following additional information should be disclosed by public construction contractors and may be disclosed by nonpublic construction contractors:

- *For performance obligations satisfied over time, an explanation of why the specific input or output method used to recognize revenue over time provides a faithful depiction of how the construction contractor transfers control of goods or services to its customers.* For example, if a construction contractor recognizes revenue based on direct labor and materials costs incurred compared to budgeted costs, it should explain why that method is a faithful depiction of how it transfers goods or services.
- *For performance obligations satisfied at a point time, the significant judgments made in determining when control of the goods or services transfers to the construction contractor's customers*.
- *The judgments involved in identifying the methods, inputs and assumptions used to determine and allocate the transaction price and measure any obligations related to the customer contract* (e.g., returns, refunds), including (but not limited to) the following:
  - If there is variable consideration, the construction contractor should explain how it estimates the variable consideration (e.g., the most likely amount method or the expected value method).
  - If there is a significant financing component, such as certain long-term payment plans, the construction contractor should disclose how it was reflected in the transaction price. Public construction contractors electing the practical expedient that results in not reflecting a significant financing component in the transaction price (see Section C.3.3) should disclose that fact.
  - If there is noncash consideration, the construction contractor should disclose how it was measured.
- *For contracts that include more than one performance obligation, the judgments involved in identifying the methods, inputs and assumptions used to (a) estimate the standalone selling price of each performance obligation and (b) allocate any discount or variable consideration included in the contract.*
- *For rights of return or refund (e.g., right of refund related to some or all of an advance payment), the judgments involved in identifying the methods, inputs and assumptions used to estimate the related obligation.*

F.1.6 Contract costs

The following information related to costs incurred to obtain or fulfill a customer contract should be disclosed by public construction contractors and may be disclosed by nonpublic construction contractors:

- A description of the judgments made in identifying the costs that should be capitalized.
- A description of the method used in each reporting period to amortize the capitalized costs and the amount of related amortization recognized for the reporting period.
- The ending balances of capitalized costs by main category of asset (e.g., incremental costs to obtain a contract, setup costs).
- Any impairment loss recognized in the reporting period related to the capitalized costs.
- If an entity elects the practical expedient allowing it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less, that fact (see Section D.2).

G. Transition

An entity may transition to the new guidance using either the full retrospective or modified retrospective method. For purposes of both transition methods, a completed contract is one for which all or substantially all of the revenue has already been recognized under legacy U.S. GAAP. In addition, the date of initial application is the beginning of the reporting period in which the new guidance is first applied by the entity. One or more practical expedients are available depending on the transition method selected.

The full retrospective transition method involves retrospective application to all periods presented. If an entity elects this method, it must provide the disclosures required for accounting changes in ASC 250, with certain exceptions, such as how the accounting change affects certain amounts in the current period income statement. This exception eliminates the need to determine the amounts that would have been reflected in the income statement if legacy GAAP had been applied in the current period.

The modified retrospective transition method involves application of the new guidance to either: (a) all contracts at the date of initial application or (b) only contracts that are not completed at the date of initial application. Prior periods are not adjusted to reflect application of the new guidance. Under this method, a cumulative effect adjustment is reflected in the opening balance of retained earnings as of the date of initial application (which is January 1, 2019 for a nonpublic construction contractor with a calendar year end that adopts the new guidance as of the applicable effective date). If an entity elects the modified retrospective transition method, a variety of information must be disclosed, including the effects of applying the new guidance in the period of adoption. In other words, an entity must determine the amount of revenue and related costs it would have recognized in the period of adoption if it had continued to apply legacy GAAP in that period, disclose the change for each financial statement item affected and explain the reasons for those changes that are significant.

H. Conclusion

This white paper provides a discussion of the new revenue recognition and contract cost guidance, focusing on those areas most relevant to construction contractors. For comprehensive discussion about the new guidance, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements and effective date and transition provisions, refer to A guide to revenue recognition.

All construction contractors whose financial statements are prepared in accordance with U.S. GAAP will be affected by the new guidance because their accounting policies for revenue recognition will need to change to reflect the five-step revenue recognition model. In addition, every construction contractor will be significantly affected by the disclosure requirements in the new guidance because they substantially increase the volume of revenue-related information disclosed in the financial statements, particularly for public construction contractors. The new guidance will require construction contractors to evaluate whether any changes are needed to their current revenue accounting and financial reporting processes, systems and procedures. This undoubtedly will require substantive involvement by more than just those involved in the accounting function.

We believe many middle-market construction contractors will need to dedicate significant resources to properly assess and implement the changes brought about by ASC 606. Because compliance may be more challenging than many believe, construction contractors should be well on their way to assessing how the new guidance will affect revenue recognition policies and disclosures, developing an implementation plan and completing that implementation plan. If you have questions about the new guidance or need implementation assistance, don’t hesitate to contact your RSM representative or Brandon Maves (+1 612 376 9324).

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