
# REVENUE RECOGNITION FOR CONSTRUCTION CONTRACTORS

**November 2025**

# TABLE OF CONTENTS

# 1. Introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)* to provide a robust framework and comprehensive principles for addressing revenue recognition issues. In addition to ASC 606, construction contractors should consider the guidance included in Subtopic 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, on recognizing a loss provision on a construction contract, if applicable. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

While virtually all aspects of ASC 606 and ASC 340-40 are relevant to construction contractors, this white paper highlights aspects of the guidance that are particularly pertinent to these entities. For additional information about all of the revenue recognition guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the guidance, refer to our revenue recognition guide.

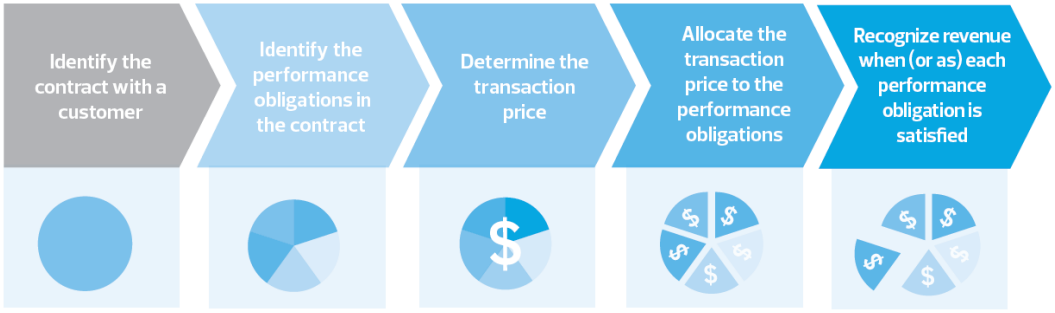
Following the release of ASC 606, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces, including the Engineering and Construction Contractors Revenue Recognition (ECCRR) Task Force, to identify and provide guidance on revenue recognition implementation issues. The culmination of the AICPA's task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the guidance.

The ECCRR task force identified seven issues that are addressed in the Revenue Recognition AAG and 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 3.2)
- *Identifying a unit of account*: How to determine a distinct performance obligation, including accounting for combined contracts (see Section 3.3 and Section 4.2)
- *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 5.2)
- *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 7.3)
- *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 7.3.1)
- *Contract costs*: Accounting for contract costs, including precontract costs and costs that qualify for capitalization (see Chapter 8)
- *Balance sheet presentation and disclosures*: Considerations for balance sheet presentation and preparing revenue recognition disclosures (see Chapter 9 and Chapter 10)

## 2. Core principle and key steps

For context, the core principle included in the guidance (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." In addition, the guidance sets out the following steps to follow when applying the core principle to revenue-generating transactions:




## 3. Step 1: Identifying 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." To account for a contract in accordance with the guidance, the following contract existence criteria must be met:

- 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)

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 a construction contractor prepares a detailed construction estimate, bid, proposal and contract. Due to the up-front effort, the contract agreement likely will evidence the payment terms and each party's performance commitments, rights and obligations when completed and approved. A more complex determination may be involved when, for example, the construction contractor 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.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized

under very limited circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received.

## 3.1 Evaluating collectibility

To meet the collectibility criterion, an entity must be able to conclude that collection of substantially all of the amount to which it will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur). For this purpose, only the customer's ability and intention to pay is considered. However, before an entity can determine whether the collectibility criterion is met, it must determine the amount that should be evaluated for collectibility. To do so, there are two primary considerations:

- *Transaction price.* As discussed in Chapter 5, the transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. An entity considers a number of factors in estimating the transaction, including whether the entity intends to offer the customer a price concession and whether the customer has a valid expectation of receiving a price concession based on the entity's customary business practices, published policies or specific statements. In general, the entity does not take the customer's credit risk into consideration when estimating the transaction price. As a result, the transaction price could be less than the contractually stated price.
- *Ability to mitigate credit risk.* An entity should take into consideration its ability to mitigate credit risk related to the transaction price (and, if so, to what extent). This is consistent with the focus of the collectibility criterion on the amount the entity expects to be entitled to for the goods or services that will be transferred to the customer, which may not be all of the promised goods or services in the contract.

  For example, if a construction contractor's ability to mitigate credit risk has historically been ineffective, 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 contractor may be able to mitigate its credit risk by having the contractual and practical ability to cease a project if the client does not fulfill its obligation to pay. 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 contractor 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.

Assessing the probability of collecting substantially all contract consideration for which it will be entitled requires judgment from construction contractors. Entities 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 contractor may need to consider the financial stability of multiple parties (e.g., owners, developers, 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 3-1: Collectibility of the Consideration – Case A – Collectibility Is Not Probable (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.

## 3.2 Contract term and the impact of customer termination provisions

Determining the contract term is important because it will affect the 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 or its customer have termination rights under the contract.

Questions 7 and 8 of the FASB's Revenue Recognition Implementation Q&As address termination rights, while Question 8 highlights 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 those penalties are substantive, 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 discussion in Questions 7 and 8 of the FASB's Revenue Recognition Implementation Q&As 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.

## 3.3 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 contracts 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 4.2) 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.

## 3.4 Accounting for 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 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 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. 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 separate contract, the termination of one contract and

execution of a new contract (prospective treatment), or an adjustment to the original contract (resulting in a cumulative catch-up adjustment).

ASC 606 provides a comprehensive model related to accounting for contract modifications. When a contract modification has been approved, the model results in accounting for the contract modification as a separate contract when it includes additional promised goods or services that are distinct and additional consideration that reflects the standalone selling prices. When a contract modification does not meet both of these requirements to be accounted for as a separate contract, it is accounted for as follows:

- *The termination of one contract and execution of a new contract (i.e., prospectively)*, when the contract modification includes only promised goods or services that are distinct from the goods or services that were transferred on or before the modification date and any additional consideration does not reflect the standalone selling prices of the additional promised goods or services adjusted for the contract's specific facts and circumstances
- *Part of the original contract (which could result in recognition of a cumulative catch-up adjustment)*, when the modified contract includes only promised goods or services that are not distinct

### 3.4.1 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 – a 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 5.2.3). 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 3-2: 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 (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 3-3: Accounting for a disputed contract claim involving a change to the contract price (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 7.3.3).

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 5.2.3) and include the estimate in the transaction price (subject to the variable consideration constraint discussed in Section 5.2.2).

# 4. Step 2: Identifying performance obligations in the contract

After contract identification (Step 1), a construction contractor needs to identify the performance obligations in the contract (Step 2). Identifying performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized.

## 4.1 Identifying promises to transfer goods or services

The first step in identifying the performance obligations in the contract is to identify all promises to provide goods or services. In many cases, identifying the promised goods or services in a construction contractor's contracts is relatively straightforward. However, in other cases, identifying the promised goods or services in contracts may not be as straightforward:

- Some activities performed by the construction contractor in fulfilling a contract (e.g., setup activities) do not transfer goods or services to the customer, and thus are not accounted for as a performance

obligation. While performing these activities is necessary to provide the promised goods or services in the contract, the activities themselves do not give rise to a promised good or service.

- While promised goods and services are most often explicitly stated in the contract, consideration also needs to be given to whether a construction contractor's customary business practices, published policies or specific statements give rise to a promise to transfer a good or service to the customer. For example, if a constructor contractor's customary business practice creates a valid expectation on the customer's part to receive training on how to use a piece of complex equipment, an implicit promise to transfer services exists that should be accounted for like an explicit promises to transfer services.

## 4.2 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 different performance obligations and accounted for separately. The determining factor in this analysis is whether each promised good or service is distinct. A promised good or service is considered distinct if it is capable of being distinct and is distinct within the context of the contract. A promised good or service that is considered distinct is accounted for separately as a performance obligation unless the series exception applies. For additional information about the series exception, refer to Section 6.3 of our revenue recognition guide.

### 4.2.1 Capable of being distinct

If a customer can benefit from the promised good or service on its own or by combining it with other resources readily available to the customer, the good or service is capable of being distinct. A promised good or service is capable of being distinct when the construction contractor regularly sells that good or service separately or when the customer could generate an economic benefit from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to the customer, it must be sold separately either by the construction contractor or another party, or it must be a good or service that the customer already has obtained.

### 4.2.2 Distinct within the context of the contract

To determine whether a promised good or service is distinct within the context of the contract, the construction contractor must ascertain which of the following best describes its promise within the context of the specific contract:

- *The promise in the contract is to transfer the promised good or service individually*. If this best describes the construction contractor's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
- *The promise in the contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the construction contractor'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 construction contractor 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? Another way to think of this question is: can the construction contractor satisfy each of the promises in the contract independent of its efforts to satisfy the other promises?

If a promised good or service is capable of being distinct (see Section 4.2.1) and distinct within the context of the contract, it is considered a performance obligation and accounted for separately unless the series exception applies (explained and illustrated in detail in Section 6.3 of our revenue recognition guide). A contract having more than one performance obligation results in the construction contractor allocating the transaction price to each performance obligation using the relative standalone selling price method (Step 4, discussed in Chapter 6) and determining 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 in time (and if so, the point in time control of the underlying goods or services transfers to the customer) (Step 5, discussed in Chapter 7).

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 other promised goods or services in the contract.

**Example 4-1: Identifying the promised goods or services and performance obligations in a contract to build a hospital (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 7.2.

The importance of properly identifying the performance obligations 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 obligations. 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 6.2) 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 in 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.

#### 4.2.2.1 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 each of the goods or services otherwise being considered satisfied over time and the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services (see Section 7.3). This exception is commonly referred to as the series exception. For additional information about the series exception, refer to Section 6.3 of our revenue recognition guide.

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 contractor's performance of standing ready is the same from day to day).

#### 4.2.2.2 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.

#### 4.2.2.3 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.

#### 4.2.2.4 Highly interdependent or highly interrelated

The FASB noted in paragraph BC111 of its basis for conclusions for ASU 2014-09 that the "highly interdependent or highly interrelated" indicator in ASC 606-10-25-21c 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 interrelated" indicator typically will not be as important for construction contractors.

# 5. Step 3: Determining the transaction price

## 5.1 General requirements for determining the transaction price

Transaction price 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)." A construction contractor may elect an accounting policy under which it excludes from the transaction price taxes it collects from its customers that were assessed by a government authority on (or contemporaneous with) the construction contractor's revenue-generating transactions with its customers. Examples of taxes to which this accounting policy would apply if elected are sales taxes, use taxes, value-added taxes and excise taxes. Examples of taxes to which this accounting policy would not apply if elected are gross receipts taxes and taxes imposed during the inventory procurement process.

If a construction contractor elects this accounting policy, it must apply the policy to all sales and similar taxes. In other words, the construction contractor cannot choose to apply the policy to some sales and similar taxes and not apply the policy to other sales and similar taxes. In addition, if the construction contractor elects the accounting policy, the accounting policy disclosure requirements in ASC 235 apply.

If a construction contractor does not elect the accounting policy, it must determine whether it is a principal or an agent with respect to each sale or similar tax assessed on its revenue-generating transactions. If it is a principal, the sales or similar tax is included in the transaction price. If it is an agent, the sales or similar tax is not included in the transaction price. Making the determination as to whether the entity is a principal or an agent with respect to each sale or similar tax in every tax jurisdiction in which its revenue-generating transactions are subject to such taxes could be a very onerous exercise. It is for this reason that the FASB provided the alternative accounting policy that an entity may elect.

In addition to the contract terms, the construction contractor'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 Section 5.2 and Section 5.3, respectively.

## 5.2 Accounting for variable consideration

Variable consideration can take many forms. For construction contractors, some common examples include 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 to which the construction contractor is entitled may be caused by explicit terms in the contract or it may be caused by an implicit price concession, discount, refund or credit that the construction contractor intends to offer the customer or that the customer has a valid expectation of receiving based on the construction contractor'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) 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).

There are certain scenarios in which an entity may not be required to estimate variable consideration as follows:

- An entity provides a series of distinct goods or services for which the variable payments relate specifically to the entity's efforts to transfer each distinct good or service within the series (see Section 8.3.2.1 of our revenue recognition guide)
- An entity is entitled to sales- or usage-based royalties and the only, or predominant, items to which the royalty relates is the license of IP (see Section 7.3.5 of our revenue recognition guide)
- An entity elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1 of our revenue recognition guide)

Outside of these exceptions, an estimate of the amount of variable consideration to which a construction contractor expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. This approach to determining the amount of variable consideration that a construction contractor should include in the transaction price suggests the contractor should:

1. Estimate the amount of variable consideration to which it expects to be entitled using either the expected value method or the most likely amount method (the specific method used depends on which will better predict the amount of variable consideration in a particular set of facts and circumstances)
2. Constrain the estimated 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

**Example 5-1: Identifying variable consideration in a contract with a penalty (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.

### 5.2.1 Estimating variable consideration

One of two methods must be used to estimate the variable consideration to which the entity expects to be entitled: the most likely amount method or the expected value method. The construction contractor 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. For estimation purposes, a construction contractor is likely to use information similar to that used in bid and proposal processes and 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 hard-and-fast rules related to when the expected value method or most likely amount method would provide the best prediction. The most likely amount method involves identifying the range of potential outcomes for the variable consideration and identifying the amount within that range that is most likely to occur. This method is likely best suited for situations in which there are a limited number of outcomes, such as when estimating a fixed-amount performance bonus (e.g., the bonus is 100% or nothing). 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.

The estimate of variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. The method used to initially estimate the variable consideration should also 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 5.2.2.

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 5-2: 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 incentivize 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, 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 facts and circumstances.

Application of the variable consideration constraint (see Section 5.2.2) was not applied to this example.

### 5.2.2 Applying the variable consideration constraint

Once the construction contractor has estimated the amount of variable consideration to which it expects to be entitled, it then needs to apply the constraint based on whether it is probable that the inclusion of the estimated variable consideration in the transaction price will not result in a reversal of cumulative revenue recognized for the contract that is significant as compared to the transaction price, including both fixed and variable consideration, 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.

Question 30 of the FASB's Revenue Recognition Implementation Q&As addresses whether the constraint on variable consideration should be applied at the contract level or the performance obligation level and states:

> … 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 considers the underlying principles on which the variable consideration constraint guidance was based, then the constraint has effectively been evaluated concurrently with estimating the variable consideration amount and the contractor does not have to evaluate the constraint separately.

Questions 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 earn variable fees or resolve disputes, claims or unapproved change orders, 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 amounts, 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 answers to many of these questions may change over time as a construction contractor gets more experience with the variable consideration guidance; estimates of variable consideration should be updated each reporting period. The entity should revise its measure of progress (e.g., estimated costs to complete the contract) as necessary as variable consideration estimates are updated.

### 5.2.3 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. 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 as a separate contract; prospectively, as if the original contract was terminated and new contract was entered into; or using a cumulative catch-up adjustment (see Section 3.4).

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 3.4 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.

**Example 5-3: 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 repave 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 ten miles on comparable terrain. Developer B and Contractor A agree on the additional ten-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 would likely be used.

### 5.2.4 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 the results of performance will meet the targeted objectives. Therefore, 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 example, a construction contractor 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.

## 5.3 Significant financing component

When a contract includes a significant implicit or explicit benefit of financing to either the construction contractor or the customer (i.e., a significant financing component), that significant financing component is taken into consideration in determining the transaction price, unless an exception applies or the construction contractor qualifies for and elects to apply a practical expedient. Reflecting a significant financing component in the transaction price incorporates the time value of money into the accounting for a contract. It is important to note that a financing component may exist in a contract when the payment terms provide for advance or deferred payments. In other words, a financing component in a contract could result in the construction contractor recognizing interest income or expense.

All the relevant facts and circumstances related to the contract should be considered in determining whether it includes a significant financing component, including:

- Whether there is a difference between the amount the customer would have had to (i.e., hypothetically) pay for the promised 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
- The combined effect of 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 and the relevant prevailing interest rates

ASC 606 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 (e.g., retention, as discussed in Section 9.3) may protect the customer if the entity fails to satisfy its contractual obligations.

ASC 606-10-32-18 includes a practical expedient that allows an entity to not adjust the transaction price for a significant financing component if, at contract inception, the entity expects to collect payment from the customer within one year from the time the good or service is transferred.

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, 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 a discount rate should take into consideration the credit risk of the entity (when advance payments are involved) or the customer (when deferred payments are involved) and 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.

**Example 5-4: Determining whether holdbacks from milestone payments that coincide with the entity's performance give rise to a significant financing component (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.

# 6. Step 4: Allocating the transaction price to the performance obligations

## 6.1 Overall allocation model

Step 4 of the five-step revenue recognition model in ASC 606 requires a construction contractor to allocate the transaction price (determined in Step 3) to each performance obligation in the contract (identified in Step 2).

The overall objective of the guidance on allocating the transaction price is to allocate an amount to each performance obligation (or distinct good or service in a single performance obligation resulting from the series exception [refer to Section 6.3 of our revenue recognition guide]) that represents the consideration to which the construction contractor expects to be entitled as a result of transferring control of the underlying goods or services to the customer.

If a 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 or variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but less than all) performance obligations. In addition, a 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. Those exceptions are discussed in Section 6.3 of this whitepaper and Section 8.3.2 of our revenue recognition guide.

## 6.2 Standalone selling prices

The standalone selling price of a performance obligation is the amount the construction contractor 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 construction contractor 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 construction contractor is required to estimate a standalone selling price. While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach

A residual approach may only be used when there is an observable standalone selling price for the other performance obligations in the contract and one of the following criteria is met:

- The prices at which the construction contractor has sold the goods or services on a standalone basis at or near the same time represents a broad range of prices within which a representative standalone selling price cannot be identified (i.e., the selling price is highly variable).
- The goods or services underlying a performance obligation have not previously been sold on a standalone basis and the construction contractor has not yet established a price for those goods or services (i.e., the selling price is uncertain).

In making this estimate, the construction contractor should maximize observable inputs and consider all reasonably available and relevant information, including information specific to the construction contractor, the market, the customer and the customer class. In addition, the construction contractor should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

### 6.3 Allocating variable consideration

Variable consideration included in the transaction price should be allocated on a proportionate basis to each of the performance obligations in a contract, except when the following two criteria are met:

- The terms of the variable payment are specifically related to the construction contractor's efforts to satisfy, or achieve a specific outcome from satisfying, a specific performance obligation or transfer, or achieve a specific outcome from transferring, a distinct good or service in a single performance obligation resulting from application of the series exception.
- Allocating the variable payment to the specific performance obligation, or distinct good or service in a single performance obligation resulting from the series exception, depicts the amount of consideration to which the construction contractor expects to be entitled in exchange for transferring that good or service to the customer when considering all of the performance obligations and payment terms in the contract.

When these criteria are met, the variable payment included in the transaction price that meets these criteria, and any change in the estimate of that payment, should be allocated in their entirety to the specific performance obligation or distinct good or service to which the variable payment relates.

The remaining transaction price is allocated as it otherwise would be under ASC 606 (i.e., allocated on a relative standalone selling price basis unless the discount exception applies [which is discussed in Section 8.3.1 of our revenue recognition guide]). Example 8-5 in our revenue recognition guide provides a detailed numerical example illustrating how to allocate the transaction price when the contract includes variable consideration.

## 7. Step 5: Recognizing revenue when (or as) each performance obligation is satisfied

Revenue is recognized when 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, a construction contractor must perform at contract inception an evaluation focused on whether a performance obligation is satisfied over time or at a point in time. Central to this evaluation is understanding what constitutes control having transferred to the customer.

## 7.1 Transfer of control

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, including the customer 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 construction contractor 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.

It is important to note:

- *The presence of an indicator is not determinative evidence that control has transferred to the customer*. For example, the customer may have legal title and physical possession of equipment transferred subject to a call option, but the construction contractor concludes the customer does not have the ability to direct the use of the equipment and receive substantially all of the equipment's remaining benefits because of that call option (see Section 9.7.1 of our revenue recognition guide). As a result, control has not transferred to the customer even though at least two of the indicators are present.
- *The absence of an indicator is not determinative evidence that control has not transferred to the customer*. For example, a construction contractor entity might retain legal title to product transferred to the customer to protect itself in case of nonpayment. If other indicators are present in this situation that cause the construction contractor to conclude that the customer still has the ability to direct the use of the product and receive substantially all of the product's remaining benefits prior to obtaining legal title, then control has transferred to the customer despite one of the indicators not being present.

For purposes of determining whether the significant risks and rewards of owning the asset have transferred to the customer, the construction contractor 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 assets included in other performance obligations in the contract for which control transfer will be separately evaluated (e.g., building maintenance after the construction period).

Determining whether control of an asset has transferred to a customer often will require judgment to be exercised and careful consideration of all the facts and circumstances.

## 7.2 Determine whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, a construction contractor 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 the construction contractor performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the construction contractor's performance at the same time as the customer receives those benefits and the construction contractor performs and creates those benefits.

  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 construction contractor.

- *Customer controls the asset as the construction contractor 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 construction contractor's performance. An entity will need to carefully consider the indicators of control discussed previously in Section 7.1 in assessing whether control of the asset passes to the customer as the construction contractor 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 for performance to date.* A performance obligation is satisfied over time if the asset created by the construction contractor's performance does not have an alternative use to the construction contractor upon its completion and the construction contractor's right to payment for its performance to date is enforceable.

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 criteria to determine whether revenue should be recognized over time or at a point in time.

If a performance obligation does not meet any of the three criteria discussed earlier, it is considered satisfied at a point in time, and the control transfer criteria discussed earlier are used to determine the point in time that control transfers to the customer.

### 7.2.1 No alternative use

In performing the assessment as to whether the asset has an alternative use to the entity, a construction contractor 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 construction contractor if it 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 construction contractor, 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 the construction contractor experiencing significant economic losses as a result of redirecting the asset for another use, the asset has no alternative use. Examples of situations in which a construction contractor could experience significant economic losses when trying to redirect the asset for another use include incurring significant costs to rework an asset because it was built to the original customer's specifications or 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 construction contractor should not consider the possibility that the customer contract could be terminated when assessing whether it could redirect the asset for another use.

**Example 7-1: Determining whether a satellite has an alternative use to the entity (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.

### 7.2.2 Enforceable right to payment for performance to date

In performing the assessment as to whether an enforceable right to payment for performance to date exists, the construction contractor 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 construction contractor not performing as promised. For this purpose, an entity is not necessarily required to conclude that it has a present unconditional right to payment and 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 construction contractor has an enforceable right to payment (by either demanding 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 construction contractor having an enforceable right to payment for its performance completed to date. The payment itself must represent proportionate compensation for the construction contractor's performance. Proportionate compensation would be an amount roughly equivalent to what the selling price would be for what the construction contractor 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 construction contractor 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.

**Example 7-2: Determining whether an enforceable right to payment for performance completed to date exists when there is a payment schedule (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 7-3: 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 (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 the customer is not consuming the entity's construction of the unit as the entity is building the unit and 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.

## 7.3 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 construction contractor is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. In the unlikely scenario that a construction contractor 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 construction contractor 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 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, construction 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 construction contractor 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 construction contractor) should be accounted for as a change in estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

### 7.3.1. 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 (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 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 a construction contractor plans to use a units-produced or units-delivered method, 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 entity's revenue. 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. Paragraph 11.5.13 goes on to say, "because many engineering procurement, and construction contracts result in the 'delivery' of an integrated set of outputs (such as a functioning power plan) and the value transferred to date during the project may not correspond directly to the right to consideration from the customer, the use of the practical expedient in FASB ASC 606-10-55-18 may not be appropriate."

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.

### 7.3.2. Input methods

Input methods rely on the efforts put forth by the construction contractor 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 the construction contractor'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.

Entities that utilize a standard costing method for inventory should evaluate the potential impact of period-end inventory cost absorption adjustments on revenue recognition. If standard costs are not current or there have been substantial fluctuations in costs, significant discrepancies may arise between standard and actual costs, which may potentially cause the recognized revenue to not accurately reflect the economic progress of the contract.

In some situations, there might not be a direct relationship between the inputs expended by the construction contractor 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 a construction contractor 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 or significant inefficiencies such as

unexpected wasted labor or materials (e.g., delays caused by third parties or the weather). 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, a construction contractor should ensure its course of action is consistent with the overall objective to measure its 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 construction contractor is not proportionate to its progress in satisfying the related performance obligation is discussed in Section 7.3.3 on applying a cost-based input method when uninstalled materials exist.

**Example 7-4: 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 Sept. 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 |
| Sept. 1 | 7,000,000 | 7,000,000 | 7,000,000 | 16,000,000 |
| Dec. 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 it:

- 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
- 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 Dec. 31, 20X1 (its calendar year end), Company A has

- Incurred construction costs of $8,500,000
- Received the Sept.1 payment of $7 million from Customer B
- Not yet received the Dec. 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 Sept. 1, 20X1 to Dec. 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:

- Incurred total construction costs to date of $16,660,000 (which includes the $1 million foundation rework costs)
- Received the Dec. 1, 20X1 payment of $7 million from Customer B
- 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 Jan. 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: Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and 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 Dec. 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 Dec. 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 Dec. 31, 20X1 are the same as Case 1. In addition, the appraisal obtained by Customer B as of Dec. 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 Sept. 1, 20X1 to Dec. 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 Dec. 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 Jan. 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 Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and 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 Dec. 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 Dec. 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.

### 7.3.3. Applying a cost-based input method when there are uninstalled materials

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 premature 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 used to measure the entity's progress and recognize revenue equal to those costs (i.e., at a zero margin).

For a construction contractor 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 materials are not distinct (i.e., they do not represent their own performance obligations).
- A significant period of time will elapse between when the customer obtains control of the materials and when the construction contractor subsequently provides the services related to those materials (i.e., installation).
- The cost of the materials is significant in comparison to the total costs expected to be incurred to satisfy the performance obligation.

- The materials are provided by a third party and the construction contractor is not significantly involved in their design and manufacture; however the construction contractor is acting as a principal under ASC 606 with respect to providing those materials to the customer.

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 construction 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*. A construction contractor 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 construction 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 7-5: Determining whether a cost-based input method should be adjusted for uninstalled materials (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:

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

## 7.4 Loss provisions on construction-type contracts

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 construction 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 contractor may be a general or prime contractor, a subcontractor, or a construction manager, and 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:<br>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.<br>b. Contracts to design and build ships and transport vessels.<br>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. | From ASC 605-35-15-6:<br>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.<br>b. Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time.<br>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 |

| Examples of contracts to which the loss provision guidance in ASC 605-35… | |
|---|---|
| **Does apply** | **Does not apply** |
| d. Contracts for construction consulting service, such as under agency contracts or construction management agreements.<br>e. Contracts for services performed by architects, engineers, or architectural or engineering design firms.<br>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. | effort under a series of existing and anticipated contracts.<br>d. Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period.<br>e. Magazine subscriptions.<br>f. Contracts of not-for-profit entities (NFPs) to provide benefits to their members over a period of time in return for membership dues.<br>g. Contracts for which other Topics in the Codification provide special methods of accounting, such as leases.<br>h. Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered.<br>i. Federal government contracts within the scope of that Topic.<br>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). |

### 7.4.1 Recognition and measurement

A construction 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 3.3). 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 construction contractor anticipates a loss on a particular unit of account, the entire anticipated loss should be recognized and measured by the construction 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.

### 7.4.2 Current estimate of contract costs

The current estimate of contract costs should include all of the fulfillment costs allocable to a contract. For its cost-plus contracts, a construction contractor also should consider whether any nonreimbursable costs should be included in the current estimate of contract costs. For all its contracts, a construction contractor should consider whether there are any costs associated with change orders accounted for as contract modifications (see Section 3.4.1) 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 construction contractor should use its normal cost accounting methods.

### 7.4.3 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 construction contractor does not expect to collect from the customer due to its credit risk and increased by the effects of removing the variable consideration constraint (if any) (see Section 5.2.2).
- *Performance obligation*. The construction 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 Chapter 6), which results in the current estimate of consideration expected to be received for each performance obligation.

It would not be uncommon for a construction 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 construction contractor recognizes a loss provision for a particular unit of account, it should include any related performance penalty. A construction 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 3.4.1) that should be included in the current estimate of consideration expected to be received.

**Example 7-6: Accounting for a loss provision on a construction contract**

Contractor A enters into a contract with Customer B on Sept. 1, 20X1 to build a new hospital for $100 million. Contractor A sets a completion date for the hospital of Aug. 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 |

| | | | | |
|---|---|---|---|---|
| Sept. 1 | 7,000,000 | 7,000,000 | 7,000,000 | 16,000,000 |
| Dec. 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 (i.e., 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 fully constrained).

Customer B already owns the land on which the hospital will be built. Based on its facts and circumstances, Contractor A appropriately concludes:

- The contract includes a single performance obligation
- The contract is satisfied over time because control of the hospital transfers to Customer B as it is built by Contractor A
- The cost-to-cost method will be used to measure its progress toward completion of the hospital

*Dec. 31, 20X1*

As of Dec. 31, 20X1 (its calendar year end), Contractor A has:

- Incurred construction costs of $8,500,000
- Received the Sept. 1 payment of $7 million from Customer B
- Not yet received the Dec. 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 Sept. 1, 20X1 to Dec. 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:

- Incurred total construction costs to date of $21 million
- Received the Dec. 1, 20X1 payment of $7 million from Customer B
- 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 fully constrained).

The following journal entry illustrates Contractor A's accounting for the revenue and costs related to its contract with Customer B from Jan. 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 Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and 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 Dec. 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.

### 7.4.4 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 presented as a reduction of revenue or 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 construction 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.

# 8. Contract costs

## 8.1 Scope

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

## 8.2 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are:

| ASC | Type of fulfillment cost |
|---|---|
| 330 | Inventory |
| 340-10-25-1 to 25-4 | Preproduction costs related to long-term supply contracts |
| 350-40 | Costs of internal-use software |
| 360 | Costs related to property, plant and equipment |
| 720-35-25-1A | Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising) |
| 946-720-25-3 | Offering costs of advisors of both public and private funds |
| 985-20 | Costs of software to be sold, leased or marketed |

**Note 1:** Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and the specific cost being evaluated.

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance. Costs to fulfill a 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).

If the criteria are met, fulfillment costs within the scope of ASC 340-40 must be capitalized. A construction contractor may not choose to expense such costs when the criteria are met.

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 7.3); 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.

### 8.2.1 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 engineering, design, mobilization or other services performed on the basis of commitments or other indicators of interest; costs for the purchase of production equipment, materials and supplies relating to specific anticipated contracts; costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of follow-on orders for the same item; and 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.

### 8.2.2 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 criteria under Section 8.2 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 paragraph 11.7.58 of 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. 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. Paragraph 11.7.55 of the Revenue Recognition AAG provides an example in which the cost of constructing the bottom floors of a ten-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 top floors.

## 8.3 Costs to obtain a contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. For a cost to

be considered an incremental cost of obtaining a contract, the construction contractor must be obligated to make a payment only as a result of entering into the contract. The incremental costs to obtain a contract should be capitalized if the construction contractor expects to recover those 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 a construction contractor 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, a construction contractor may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the construction contractor 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.

### 8.4 Amortization and impairment of capitalized costs

ASC 340-40 provides guidance on amortizing costs capitalized in accordance with its provisions as well as testing those capitalized costs for impairment. This guidance is summarized and illustrated in Sections 13.3 and 13.4 in our revenue recognition guide.

## 9. 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 (see Section 9.3), 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.

### 9.1 Accounts receivable

When determining the amount of the contract asset or liability to be recognized (if any), the construction contractor 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 construction contractor 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*.

## 9.2 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 plus any amount 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 construction contractor'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 plus any amount 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 construction contractor'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 construction contractor 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.

## 9.3 Classification of retentions

In the construction industry, it is common practice for customers to withhold payment of a set amount or a percentage of a contract price until completion of the project or a time specified in the contract. This amount is generally referred to as a retention. Retention is a practice used to create an incentive for the contractor to complete their work appropriately and timely and protects the customer from the contractor failing to adequately complete their obligations under the contract. As noted in Section 5.3, retention terms are generally not considered a significant financing component of the transaction price, as the reasons for withholding payment are not related to financing. However, the customer may have an unconditional obligation to pay the amount being held back as retention for the work already performed.

Paragraph 11.7.32 of the Revenue Recognition AAG states that "retention receivables should be carefully assessed to determine whether retentions are subject to restrictive conditions, such as fulfillment guarantees. Where retentions are subject to conditions other than passage of time, such as fulfillment guarantees, future performance, or achievement of stated milestones, amounts related to retention receivables would continue to be classified as a contract asset until such time that the right to payment becomes unconditional."

In paragraph 11.7.33, the AICPA goes on to say that "[w]here construction contracts include termination clauses such that the contractor has the right to payment, including profit, for work performed to date upon customer termination, the inherent condition to payment may relate solely to passage of time (such as, time and materials, or cost-reimbursable type contracts where no milestone or performance-based billing requirements exist), and as a result, FinREC believes unbilled work-in-progress should be reclassified to unbilled receivables."

When evaluating retention, it is important to assess whether the entity's right to the retention is dependent upon factors other than the passage of time.

Because the definition of a receivable is ultimately a question of whether a legal right to payment exists, careful assessment of the contract's legal terms and conditions is crucial and may require client consultation with legal counsel to determine if the retained amount is contingent upon anything except the passage of time.

## 10. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): "The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

The disclosures required to achieve this objective focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. However, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations
- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and elective for nonpublic entities)
- Capitalized costs related to obtaining or fulfilling a customer contract (disclosures required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the construction contractor is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required for interim periods. However, when a construction contractor applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the construction contractor must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

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