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Revenue Recognition Becomes a Little Different in December

A guy walks into a bar and says to a man seated on a stool, "Hi, I'm Revenue." Wouldn't that make life easier if your company's revenue just walked right up and shook your hand. Every couple of years, the Accounting Standards Board believes accountants and businesspeople are getting too comfortable and throw out a curveball to make CPAs and their clients a little uncomfortable for a while. That's what the Financial Accounting Standards Board did in 2014 with ASC 606, *Revenue for Contracts with Customers* and will do again at the end of this year.

The new standard requires the following multi-step process to determine how and when to recognize the revenue:

1. Identify the contract
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate obligations of the contract, and
5. Recognize revenue when or as the obligations are me.

The first two steps are not that difficult – identifying the existence of a contract or an enforceable right and determining the obligations presented by those contracts. But have the contractor and client agreed to terms, and, if so, what are those terms? In addition, the payment terms and the probability of collection also must be determined.

When determining the existence of the contract, one should also ascertain the performance obligations. In many cases, this may be easy, such as "build an addition to the school." However, the contract may include other performance obligations, such as "build a library building and playground," all of which could be separate performance obligations. More often than not, though, the obligation is singular, as there are no separate deadlines and separate deliverables.

Ultimately, the second step requires a determination whether the performance obligation identified can stand on its own. Is the intent of the contractor and school to put each separate part into operation as soon as it is finished, or must the contractor transfer the project to the school after both parts have been completed? The playground and library building could be the two separate performance obligations.

The fun comes after those two easy steps are completed. The next step is to determine the transaction price, which requires variable considerations. Unlike the current standards, the new one allows recognition of certain variable revenue. However, you have to determine the likelihood this can happen through either the "expected value" method or the "most likely amount method." In the example of the library and playground, your contract cost is $1 million with a 10 percent bonus if completed before July. In using the most likely amount method, it is the start of the dry season in Louisiana and the typical contract runs ahead of schedule because of the lack of rain, so there is an 80 percent chance the contract will be finished. The contractor would recognize the variable consideration, and revenue for the contract would be $1.1 million.

Once the price is determined, it must be allocated to the separate obligations. There are three methods that may be used to allocate the price:

- The "adjusted market approach" requires determination of what the customer would pay for each separate piece of the obligation.
- Under the "expected cost plus margin," consider the cost of each obligation cost plus the contract markup.
- Finally, there is the "residual approach," which is only used when either the current stand-alone prices are widely ranged or the item has never been sold.

Using the cost plus margin method for our school and playground, we know the costs for the school and playground typically are $600,000 and $200,000, respectively, and we build 20 percent profit into our bid, so the final transaction price for each would be $750,000 and $250,000, respectively.

After the first four steps, revenue can be recognized either at a single point in time or over a set period of time. In most cases, a contractor will recognize it over time. Once the timing is determined, it is necessary to decide the method of recognition – the "input method," which relies on labor hours or accumulated costs of production, or the "output method," which considers progress measured by units of output or milestones. The percentage of completion is an example of this former method.

Under the input method, the contractor would recognize costs and subsequently project out the revenue they would earn like prior to the new standard. In this case, the contractor would include the variable consideration in the projection, unlike before.

KEY TAKEAWAY: Don't lose sleep just yet over how to implement this into your business model; however, controllers and contractors in the construction industry need to begin to determine the processes and controls necessary to ensure an easy transition. The new curveball takes effect for public companies for years beginning after December 15, 2017, and others a year after that.

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