Revenue Recognition Exposure Draft Revised:

WHAT CFMs NEED TO KNOW

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For 30 years, U.S. construction companies have primarily followed one standard of accounting for revenue recognition: ASC Topic 650 (formerly Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts)* (hereafter SOP 81-1).

On November 14, 2011, FASB and IASB (the boards) issued their *Proposed Accounting Standards Update (Revised) Exposure Draft*, which is likely to become a final standard in 2012. Once effective, it will replace SOP 81-1 and most existing revenue recognition and construction cost accounting guidance under U.S. GAAP and IFRS.

Exposure Draft History

In June 2010, the boards released the original Exposure Draft that proposed a new revenue recognition model. Approximately 1,000 comment letters were submitted, with more than 25% of the responses from constituents in the construction industry. The boards' redeliberations maintained certain conclusions from the original Exposure Draft; however, many of the original proposals have changed significantly in the Revised Exposure Draft, which include several areas relevant to the construction industry:

- Whether and when to separately account for more than one obligation in a contract;
- The amount of revenue that can be recognized; and
- Whether revenue can be recognized continuously over the contract period.

Most in the construction industry view the totality of these changes as a "win," due in large part to the high level of interaction between the boards and industry stakeholders (most notably CFMA members). CFMA's collective and individual member interactions with the boards were frequent and substantive, which played a major role in the standard-setting process.

Original Exposure Draft

The original Exposure Draft was built on a core principal that an entity should 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 to receive in exchange for those goods or services.

It also provided five steps for applying this core principle:

1) Identify the contract with a customer.

2) Identify the separate performance obligations in the contract.

3) Determine the transaction price.

4) Allocate the transaction price to the separate performance obligations in the contract.

5) Recognize revenue when (or as) the entity satisfies a performance obligation.

Revised Exposure Draft Changes

While the core principle and five steps have remained relatively unchanged in the Revised Exposure Draft, several key elements within these steps have changed. This article will focus on the most significant changes from the original Exposure Draft that will impact the construction industry.

Step 1: Identify the Contract with a Customer

This step includes guidance related to contract modifications such as change orders and claims. The original Exposure Draft required that in order to recognize revenue from a contract modification, the entity had to meet the same standards applicable to the original contract.

Conversely, much like SOP 81-1, the Revised Exposure Draft recognizes the range of contract modifications that may exist – those which have not yet been approved by both parties; those which have been approved by both parties as to scope, but not as to price; and finally, those which have been approved as to both scope and price.

Detailed guidance is provided for determining the proper accounting in each circumstance, and while there will still be some differences in the timing and amount of revenue recognition from contract modifications in the new standard compared to SOP 81-1, it will bear a much stronger resemblance to the SOP 81-1 guidance than under the original Exposure Draft.

Step 2: Identify the Separate Performance Obligations in the Contract

While the original Exposure Draft presented criteria that would have frequently required a single contract to be accounted for as more than one performance obligation, the Revised Exposure Draft contains language that may permit companies to account for one or more goods or services in a contract as a single performance obligation.

Specifically, the Revised Exposure Draft contains guidance indicating that if an entity promises to transfer more than one good or service, then the entity would account for each separate good or service as a separate performance obligation *only* if it is distinct. If the promised good or service is not distinct, then the entity would combine that good or service with other promised goods or services until the entity identifies a bundle of goods and services that is distinct.

While "distinct" is defined within the Revised Exposure Draft, additional guidance is provided to clarify that a good or service in a bundle of promised goods or services is not distinct as long as 1) the goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity to provide significant integration services and 2) the bundle of goods or services is significantly modified or customized during the fulfillment of the contract.

With this text in the Revised Exposure Draft, it is now likely that many construction contracts will be accounted for as single performance obligations, similar to the guidance contained in SOP 81-1. Accordingly, we will not devote content in this article to Step 4.

Steps 3 & 5: Determine the Transaction Price & Recognize Revenue

Steps 3 and 5 work in conjunction with each other, so we'll review them together. In the original Exposure Draft, the transaction price was to be the probability-weighted amount of consideration that an entity would be expected to receive. However, under the Revised Exposure Draft, the transaction price is the amount of consideration to which the entity expects to be entitled (using a probability-weighted or most likely amount approach). This change recognizes the reality of incentive pricing that typically exists in the construction industry, which is frequently a binary incentive (either a deadline is met and an incentive is earned or it isn't).

However, there is also a constraint in the recognition of revenue that limits the amount of revenue an entity is permitted to recognize to only the consideration that the entity is reasonably assured to be entitled. External factors outside of the entity's influence (such as weather conditions) will likely influence an entity's ability to determine when the amount of consideration is reasonably assured of being received.

The Revised Exposure Draft also contains clarifying language that will likely be welcomed by the construction industry. Specifically, for performance obligations that an entity satisfies over time, an entity shall recognize revenue by measuring the progress toward complete satisfaction of that performance obligation.

When measuring progress, the objective is to depict the entity's actual performance toward satisfying its promise to deliver goods or services. Since circumstances change over time, the Revised Exposure Draft calls for an entity to update its measure of progress to depict the performance completed to date. Any changes are required to be accounted for as a change in accounting estimate in accordance with ASC Subtopic 250-10 on accounting changes and error corrections.

Considerable guidance is provided on the use of input and output methods in measuring progress toward completion. In summary, input methods are generally permissible, particularly when output methods are difficult and costly to measure (a clarification from the original Exposure Draft).

Other Considerations

Contract Costs

The Revised Exposure Draft specifies that costs related to fulfilling a contract may, within certain limits, be capitalized and charged to expense as the related goods and services are transferred. Incremental costs to obtain a contract would be treated similarly if the entity expects to recover those costs during the performance of the contract.

Warranties

Some construction companies account for warranties as cost accruals outside of the percentage-of-completion method (PCM) while others account for them as part of the PCM. Given that all warranty guidance will be codified in one standard, practice will likely become less diverse as a result of this proposed standard.

Warranties that a customer has the option of purchasing separately or that contain a service element (e.g., maintenance) create a separate performance obligation and revenue is therefore deferred until that obligation is satisfied. If, however, a customer does not have the option to purchase a warranty separately (e.g., many standard-type warranties), then the warranty should be accounted for as a cost accrual. For those companies that determine use of cost-to-cost is an appropriate measure of control transfer, warranty costs would generally be considered a contract fulfillment cost and therefore included in this assessment.

Loss Provisions

The boards have clarified that the assessment of onerous performance obligations (i.e., loss contracts) only applies to performance obligations satisfied over a period of time greater than one year. A performance obligation is onerous if the lower of either 1) the costs that relate directly to satisfying the performance obligation or 2) the amount the entity would pay to exit the performance obligation exceeds the amount of revenue allocated to that performance obligation.

Two significant changes from current accounting exist. First, this assessment is performed at the performance obligation level, not the contract level. So, contractors might need to recognize a loss provision on a contract that is profitable in total, but that contains a separate performance obligation that is assessed as onerous. Second, the costs used in making this assessment are different. Including costs to exit the performance obligation, if lower than the remaining direct cost to fulfil, may result in fewer loss provisions recorded under the proposed standard as compared to today.

Summary

Many of the changes in the Revised Exposure Draft strike a balance between the economics of transactions and the unique aspects of our industry.

A final standard is expected in late 2012, with an effective date likely no earlier than 2015. Notwithstanding this date, CFMs should continue to be engaged in the process and begin to evaluate how the model will impact their companies.

In addition, pay particular attention to the possible impact on bank convents and key bonding metrics. These changes will likely reach far beyond the finance function and into such areas as IT, HR, and field operations.

Above all else, user education is most critical. CFMA's Emerging Issues Committee will continue to keep members informed, including a more in-depth article in a future issue and a KnowledgeNOW Webinar on December 21, 2011. (For more on the Webinar, visit *www.cfma.org/upcoming_webinars.*) ■

A version of this article appears in the November/December 2011 issue of *CFMA Building Profits*.

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