LAPORTE
CPAs & BUSINESS ADVISORS

CICPAC
CPAs WHO KNOW CONSTRUCTION

Revenue Recognition Overview
TERMINOLOGY & CONCEPTS

Sponsored by: Foundation Software

Published: November, 2019

Key Terms for Understanding Revenue Recognition

Since May 2014, we have been investigating the future impact and implementation of ASC 606, the new revenue recognition standard. This industry-standard revenue recognition model was designed to help streamline company and industry financial statements for comparability, with the overall goal to decrease the complexity of revenue recognition.

Part of learning the standard is understanding the terminology and concepts. CICPAC has compiled this Revenue Recognition Terminology & Concepts document to summarize the new terms as they relate to the old terms or to define what the new terms are referencing.

Please use this document in conjunction with CICPAC's previously released Revenue Recognition Implementation Guide, which includes topics related to:

- Identifying contracts with customers
- Assessing multiple performance obligations
- Series of performance obligations
- Evaluating variable consideration
- Uninstalled materials
- Recognizing revenue
- Fulfillment costs
- Capital costs to obtain a contract
- Financing
- Transition method
- Disclosures

Any questions related to this terminology sheet or the Revenue Recognition Implementation Guide can be directed to:

LaPorte CPAs & Business Advisors

Christina Chifici, CPA, CCIFP
cchifici@laporte.com
(985) 892-5850

Tracy Tufts, CPA, CCIFP
ttufts@laporte.com
(504) 835-5522

Daniel Williams, CPA, CCIFP
dwilliams@laporte.com
(225) 296-5150

Key Terms for Understanding Revenue Recognition

Pre ASC 606	New Standard Terms & Concepts
Contract Each contract was the default profit center. Segmenting was permitted, but margins on "phases" had to vary significantly and certain criteria had to be met. Though uncommon, combination of contracts so closely related they could not be accounted for separately was also permitted.	**Performance Obligation** The focus shifts to identifying promises to deliver goods or services, or performance obligations, within the contracts. You must segregate performance obligations within a single contract, if distinct, within the context of the contract—it is separable in delivery and the customer can separately benefit from the rest of the project. Similarly, two or more contracts may need to be combined if they are negotiated as a package, resulting in one performance obligation, and the consideration to be paid under one contract is dependent on the outcome of the other. It is generally expected that most individual contracts will continue to serve as the profit center under the new standard. **Multiple Performance Obligations** When multiple performance obligations (distinct goods and services) are present within a contract, the standard requires the transaction price (overall contract value) be allocated to the separate performance obligations.
	Distinct Good or Service Goods and services are distinct if both of the following are met: • The customer can benefit from the goods and services on their own or with other readily-available resources (capable of being distinct); and • The contractor's promise to transfer goods and services is separately identifiable from other promises in the contract (distinct in the context of the contract).
Contract Value The original contract price plus any approved change orders and certain amounts for unapproved or unpriced change orders.	**Transaction Price** The total amount of fixed and variable consideration in a contract you expect to be entitled to as you deliver design or construction services. This total is allocated to any separately identified performance obligations within the contract based on relative standalone (actual or estimated) selling prices. Note: It may not be the stated contract price due to **variable considerations**. Variable consideration includes incentives and bonuses, cost saving sharing, liquidating damages and other penalities, materials rebates and discounts, and more which should be recorded at their most likely or expected amount.

Key Terms for Understanding Revenue Recognition

Pre ASC 606	New Standard Term(s) & Concepts
Uninstalled Materials The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress—ordinary percentage of completion accounting applies. If not specifically produced, fabricated, or constructed for a project (could be installed on another project), the cost of the materials should be capitalized and reported as inventory until installed.	**Uninstalled Materials** Just as before, determine if costs of uninstalled materials should be accounted for as inventory and capitalized. If you determine the uninstalled items are not inventory, reflect them as project costs. If reflected as a project cost, determine if the costs incurred for uninstalled materials are not significant to the contract or are proportionate to progress under the performance obligation—include in POC calculation if so. More likely, they will not be proportionate until installed. In this case, remove any significant uninstalled material cost amounts from both the transaction price and estimated project costs before determining percentage of completion. Assuming certain conditions are met, add back the uninstalled materials cost amount to revenues determined under POC to arrive at the total revenue to be recognized. The mark-up on those materials is recognized as the materials are installed.
	Distinct Good or Service Goods and services are distinct if both of the following are met: • The customer can benefit from the goods and services on their own or with other readily-available resources (capable of being distinct); and • The contractor's promise to transfer goods and services is separately identifiable from other promises in the contract (distinct in the context of the contract).
Customer-Furnished Materials The value of materials supplied by the customer is added to contract revenues and costs only if the contractor bears the risk of nature, type, characteristics, specification, or ultimate performance of such materials within the overall project.	**Noncash Contribution** The fair value of materials furnished by customers but controlled by the contractor shall be considered noncash consideration, estimated and included in the transaction price and estimated costs. If the contractor controls customer-contributed equipment or services, the fair value of such noncash consideration should also be estimated and included in the transaction price.
Wasted Materials and Rework The cost of wasted materials and rework is currently included as a job cost. Total estimated job costs are re-estimated periodically to incorporate impacts of all over- and under-runs.	**Wasted Materials and Rework** These costs are what they are. The difference under the new standard is that, if significant, waste and rework should not be added to total estimated costs for inclusion in determining POC and recognizing revenue. The reason: These costs are not held as being indicative of making progress on a performance obligation. However, other types of cost over-runs are reflected within updates to total estimated job cost.

Key Terms for Understanding Revenue Recognition

Pre ASC 606	New Standard Term(s) & Concepts
Change Order Generally, an approved, priced change order would be added into total estimated contract revenues and costs with cumulative adjustment of revenues and profit recognized based on the combined overall amended margin and percentage of contract completion.	**Contract Modification** You must consider if each modification to a contract is a distinct good or service, and priced as such, in which case it should be accounted for as a separate performance obligation. If not, there are two considerations: 1) If the remaining goods or services to be delivered under the modified contract are distinct from others already delivered under the contract, prospective adjustment based on remaining estimated costs and revenues is warranted; 2) If not, back to the old way of doing things! Revenue recognition should be considered even if the final scope and price have not been determined. See Contract Modifications with Variable Consideration.
Unsigned or Unpriced Change Orders or Claims If approval and collection from the customer was probable, you would recognize revenue up to amount of costs incurred.	**Contract Modifications with Variable Consideration** This area is more complicated. If scope changes are approved, but the pricing is not yet determined, you should estimate the contract modification price, determine whether to update or segregate the modification from the transaction price, and recognize revenue to the extent you believe a significant reversal will not occur in the future. There are a couple methodology choices—use the "most likely amount," or calculate a probability-weighted "expected value." For unsigned change orders and claims, first consider if the rights and obligations created under the contract modification are enforceable. If so, the same procedure applies—recognize revenue to the extent you believe a significant reversal will not occur in the future. If not enforceable, just recognize the added costs until approval is obtained.
Bonus/Award or Liquidated Damages (LDs) Measurable bonuses or awards are currently not included in contract revenues until it is probable performance requirements will be met or exceeded—generally at or near the end of the contract. LDs and other penalties are assessed for probability of incurring penalties on an ongoing basis and recognized as a reduction in contract value when identified as probable.	**More Variable Consideration** No change in terminology, but a significant change in how to account for these provisions. For bonuses or awards, include the expected or most likely amount of estimated bonuses in the overall transaction price (total contract revenues) if it's probable a significant reversal in the total amount of revenue recognized will not occur. For penalties such as LDs, include amounts expected or most likely to be incurred as a reduction in the transaction price. These estimates would be updated, and catch-up adjustments made as necessary, each year.
	Variable consideration is recognized only to the extent that it is probable that a significant reversal (constraint) in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Key Terms for Understanding Revenue Recognition

Pre ASC 606	New Standard Term(s) & Concepts
Retention-Disclosure Only Required The concept of an operating cycle equal to the length of a contract in SOP 81-1 shielded contractors and A/E firms from having to consider discounting retention stretch out more than one year. Disclosures of retention totals and the amount collectible more than one year from the reporting date covered.	**Retention - Is It a Significant Financing Component?** The time value of money must be considered when arriving at the transaction price. A significant financing component exists when the timing of payments per the contract provide the customer with a significant benefit of financing. Retention is intended to give the customer assurance the project will be completed; it is not intended to be a benefit of financing and, thus, does not typically constitute financing. All other prior disclosures continue to apply. For other payments, elect the available practical expedient to ignore a financing component in situations where payment will be received under the initial contract within one year of transferring the performance obligation tothe customer. Otherwise, if such other payments are significant and will not be collected within one year of the transfer of goods and services, the new standard requires those amounts be discounted using a relevant rate. The discount amount would be recognized as interest income.
Certain Contract Costs Costs incurred at the beginning of the contract such as bonding, insurance and mobilization (now called fulfillment costs), were included in total estimated cost to complete and costs incurred to date on projects. Generally, they were simply included as costs incurred to-date to measure percentage complete.	**Fulfillment Costs** The general guidance for identifying fulfillment costs are that the cost must: a. relate directly to a contract or anticipated contract or an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved), b. generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future, and c. are expected to be recovered. These costs should be capitalized and amortized over the term benefit is derived.
Precontract Costs Under ASC 720-15, all costs incurred before a contract is awarded, were to be expensed as start-up costs. Costs incurred after the award that would be recovered, could be reflected as a project cost.	**Incremental Costs of Obtaining a Contract** These are costs that the contractor would not have incurred if the contract had not been awarded to the contractor. These costs are to be capitalized on the balance sheet and then amortized on a basis consistent with the transfer of the goods or services to which the amounts relate. Note that the unamortized costs are to be evaluated annually for impairment. **Note**: An entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Key Terms for Understanding Revenue Recognition

Pre ASC 606	New Standard Term(s) & Concepts
Unbilled Receiveables or Costs and Estimated Earnings in Excess of Billings of Uncompleted Contracts	**Contract Asset** A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer, when the right is conditioned on something other than the passage of time. Contractors can still call such assets by their former names. Disclosures must just provide sufficient information so that users of the financial statements can clearly distinguish between an unconditional right to consideration (a receivable) and a conditional right to receive consideration (a contract asset).
Deferred or Unearned Revenue or Billings in Excess of Costs and Estimated Earnings on Uncompleted Contracts	**Contract Liability** If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity should present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer. Same as above, it is important to ensure disclosures relate what the contract-related liabilities are.

Sponsored by:

For over 30 years, Foundation Software has assisted thousands of labor-intensive contractors with FOUNDATION®, America's #1 Construction Accounting Software. Featuring Microsoft® SQL Server®, FOUNDATION is powerful yet flexible and suits a wide range of construction trades. FOUNDATION offers instant construction reporting PLUS: robust job costing, payroll and standard modules to handle all daily accounting functions. Additional modules include FOUNDATION mobile®, a remote timecard and field log app for mobile devices; Project Management, Document Imaging and Routing; an Executive Dashboard for instant graphical reporting; Service Dispatch; Scheduling; and more. The system is available as a traditional on-premise installation or on the cloud as FOUNDATION SaaS (software-as-a-service).

Special thanks to BerryDunn for content assistance and technical review.

Thank you also to KatzAbosch for technical review.