



REVENUE RECOGNITION: CONSTRUCTION AND REAL ESTATE

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The following are the most significant impacts ASC 606 will have on the engineering and construction industry:

- Current forms of recognizing revenue are the percentage-of-completion (POC) method and the completed contract (CC) method. POC is preferable under generally accepted accounting principles but CC can be used in certain circumstances.
- Under ASC 606, a “one size fits all” approach **will no longer be accepted**. Each contract will need to be reviewed under a five-step process, which may lead to a different answer for each contract and/or distinct performance obligation of the contract.
 - Changes can happen quickly in the engineering and construction industry, and the existence of a contract that creates enforceable rights and obligations—and is agreed to by both parties, signed and in place before work begins—is very important. The first step in applying ASC 606 is checking whether these **conditions are present**: (1) The contract must be approved (written, oral, or other customary business practices) with commitment by the parties to perform their respective obligations; (2) each party’s rights can be identified; (3) the payment terms are identifiable; (4) the contract has commercial substance; and (5) collection of payment is probable.
 - Contracts will need to be evaluated from **the customer’s perspective** to determine how many distinct performance obligations exist. General contractors often have multiple subcontractors and may at first think each of these subcontracts represents separate performance obligations. Yet if the customer’s perception is that the general contractor is completing a single project, there is still only one performance obligation.
 - Determination of the transaction price will require **much more analysis** on the front end. Entities will need to estimate variable consideration such as penalties, performance bonuses, retention, and cost sharing. These may be partially or fully constrained to the extent that it is probable a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is subsequently resolved.
 - **A similar process to POC is allowed**; under ASC 606, this is the recognition of revenue “over time” if any of the following are true: (1) The customer simultaneously receives and consumes the benefits; (2) the entity’s performance creates or enhances an asset that the customer controls (such as constructing a road or structure on the customer’s property); or (3) the entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. If none of those are in place, recognition of revenue at a “single point in time” (similar to CC) is the likely outcome.
- Contract modifications such as change orders and claims are subject to certain criteria that will dictate how they are handled, which may include being accounted for within the existing contract or as a separate contract, depending on the circumstances.
- ASC 606 also includes requirements for **much more extensive qualitative and quantitative financial statement disclosures**, which may be challenging and may require significant management judgement. As a result, it is expected that organizations will need to update/develop a comprehensive policy describing the methods, inputs, and assumptions used to record revenue.
- Entities may need to modify their systems and processes to gather information about contracts with their customers that is not otherwise readily available. Contracts may need to be rewritten or renegotiated. Debt covenants may need to be renegotiated. Business practices such as employee performance bonuses and sales commissions may need to be reconsidered.

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REVENUE RECOGNITION

In May 2014, the Financial Accounting Standards Board (FASB) completed its revenue recognition project by issuing Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which can be found in the new Accounting Standards Codification (ASC) Topic 606.

Effective Dates

PUBLIC ENTITIES

Reporting periods beginning after December 15, 2017

Public entities include:

- Public business entities
- Not-for-profit entities that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market
- Employee benefit plans that file or furnish financial statements to the SEC

OTHER ENTITIES

Reporting periods beginning after December 15, 2018

Who will be impacted?

One common misconception is that the new standard will apply only to organizations in certain industries when, in fact, the standard will apply to all organizations that generate revenue from contracts with customers. While there is no doubt some industries will see a greater impact than others, all organizations will have to consider and respond to the new principles.

When should planning start?

Another misconception is that there is plenty of time to address the new standard. However, delaying implementation could make it difficult to adopt the standard by the effective date, especially when long-term contracts are involved. Organizations that start planning now will also have more time to consider and prepare for practical changes to contracts and accounting systems.

REVENUE RECOGNITION

What is changing?

Under existing standards, revenue is generally recognized when it has been earned and/or is realized (or realizable) based on some commonly applied criteria, including:

- Evidence indicates an arrangement exists.
- Goods or services have been delivered.
- The price is fixed or determinable.
- Collectability is reasonably assured.

Organizations operating in certain industries must also apply industry-specific rules to determine when and how revenue for contracts should be recognized.

The five-step principle

Revenue will be recognized under ASC 606 when a performance obligation is satisfied by **transferring control** of the product or service to the customer. The new standard replaces all of the existing revenue recognition guidance and industry-specific rules with a five-step, principle-based model that all organizations will use. To implement ASC 606, organizations will need to understand and develop a plan to incorporate these five steps into their accounting processes and practices.



1. Identify contracts with customers



2. Identify performance obligations (promises to deliver) in each contract



3. Determine the transaction price



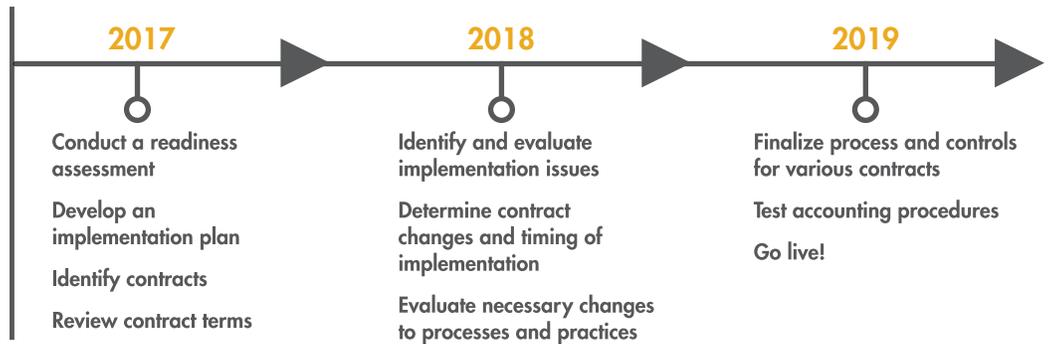
4. Allocate the transaction price to the performance obligations



5. Recognize revenue when or as performance obligations are satisfied

What should I do now?

The first step is to develop an action plan to make the transition to the new standard as smooth as possible. Here are some broad goals a nonpublic entity might consider.



Wipfli is here to help

Wipfli associates are monitoring the latest implementation guidance from the FASB and AICPA, and we are ready to help our clients as they implement ASC 606. Wipfli can help with:

- Readiness assessments
- Changes to accounting systems
- Implementation plans
- Evaluating impact on financial reporting (e.g., loan covenants)
- Reviewing contract terms
- Training and education (e.g., *Accounting Wire*, industry newsletters, webinars)
- Recommending contract changes

Get started today!

Contact your Wipfli relationship executive to learn more about revenue recognition for your organization.

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