Revenue Recognition: FASB's New Standard Is No Longer Near — It's Here

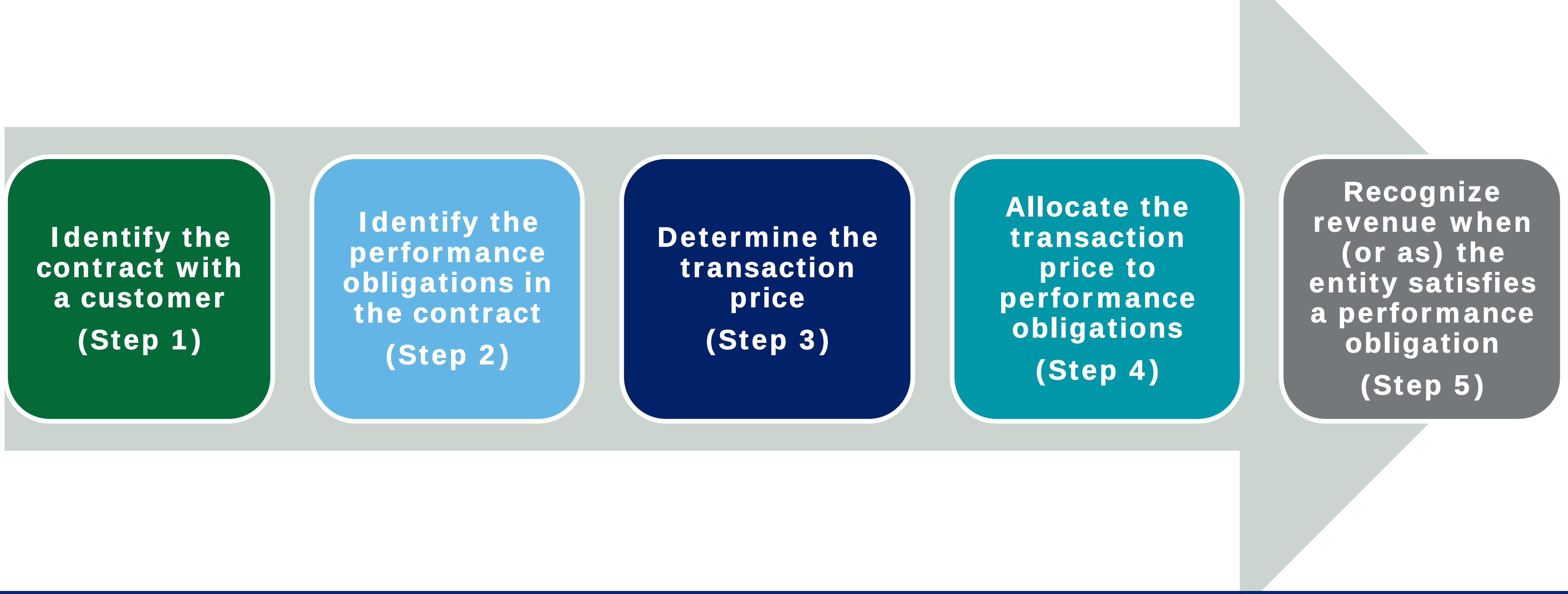
2017 Engineering and Construction Conference

Overview

New revenue guidance

The five-step model

Core principle: Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration the entity expects to be entitled in exchange for those goods or services



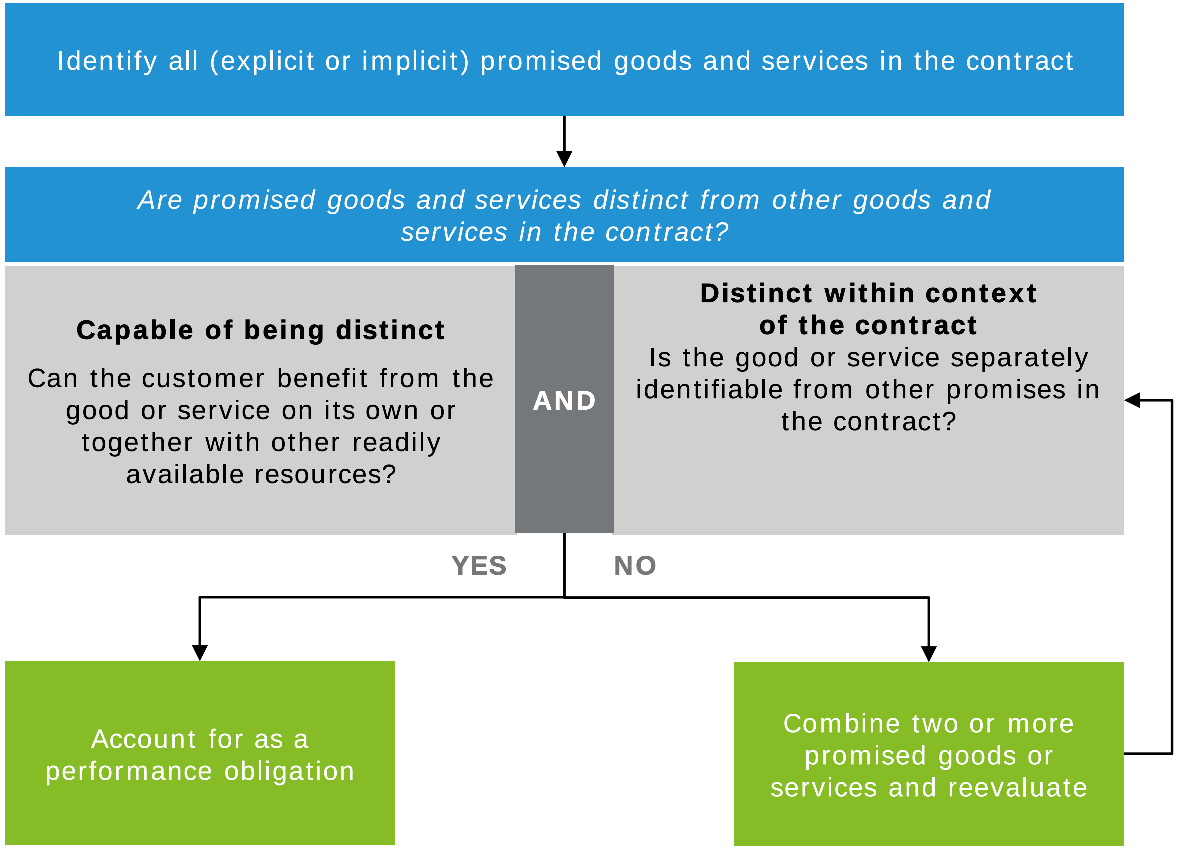
This revenue recognition model is based on a control approach, which differs from the risks and rewards approach applied under current U.S. GAAP

Technical issues for the E&C Industry

Performance obligations

Identifying performance obligations

A **performance obligation** is a promise to transfer to the customer a good or service (or a bundle of goods or services) that is **distinct**



FASB updates – ASU 2016-10

Distinct goods or services

- Clarifies the meaning of a promise that is <u>separately identifiable</u> (paragraph 606-10-25-21) and revise the related factors to align with that clarification

As amended:
In assessing whether an entity's promises to transfer goods or services to the customer are **separately identifiable** in accordance with paragraph 606-10-25-19(b), the objective is to determine **whether the nature of the promise, in the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs**. Factors that indicate that two or more promises to transfer goods or services to a customer are not separately identifiable include, but are not limited to, the following:

a. The entity provides a **significant service of integrating** the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
b. One or more of the goods or services **significantly modifies or customizes**, or is significantly modified or customized by, one or more of the other goods or services promised in the contract.
c. The goods or services are **highly interdependent or highly interrelated**. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract …

- Amends and adds examples to the standard's implementation guidance (paragraphs 606-10-55-137 to 157AE)

Task force guidance — Determining performance obligations

An entity may consider the following factors that indicate that the promised goods and services in a design, development, and production contract are not separately identifiable in accordance with FASB ASC 606-10-25-19(b) and therefore not distinct:

- During the bidding process, the customer did not seek separate bids on the design and production phases
- The contract involves design and production services for a new or experimental product
- The specifications for the product include unproven functionality
- The contract involves the production of prototypes or significant testing of initial units produced for the purpose of refining product specifications or designs
- The design of the product will likely require revision during production based on the testing of initial units produced
- It is likely that initial units produced will require rework to comply with final specifications

Variable consideration

Unfunded Portions of US Government Contracts

It is common for contracts to extend over a number of years and contracts with the USG may be only partially funded at the inception of the contract because of its annual budget process.

In determining the transaction price for a contract, the unfunded portion of a contract could be considered variable consideration, similar to award fees and incentive fees included in contracts because they too are not funded.

If an entity concludes that it is probable that the unfunded portion of the contract will become funded, an entity would include the unfunded portion of the contract in the transaction price prior to the funding being appropriated and continue to recognize revenue in excess of funding.

Unfunded portions of USG contracts generally considered collectible if part of an enforceable contract (with funded portions) and could be treated as variable consideration.

Change orders, unpriced change orders, unapproved change orders/claims

- Change Orders need to apply the modification guidance and apply accordingly
- Unpriced Change Orders would also apply the modification guidance, however, the value of the variable consideration would need to be estimated, and then constraint applied
  - If the entity determines that it is probable that some or all of its estimate will not result in a significant revenue reversal, that amount is included in the transaction price
    - Can an entity estimate the amount that is probable of not resulting in a significant reversal of revenue on a cumulative basis?
    - What if the amount is in dispute with the customer?
- The Financial Reporting Executive Committee (FinREC) believes certain types of variable consideration, including unapproved change orders and claims, may often only be recorded when settled or received.
  - Once applying the constraint, the entity might determine that it is probable that some of the estimate of the variable consideration in the transaction price would not result in a significant revenue reversal
  - Much higher hurdle for claims given that a 3rd party may often be involved in the determination of the final amount of variable consideration

Liquidated damages

- Determining the method of estimating according to ASC 606-10-32
  - The Most Likely Amount Method: Is the variable consideration based on a binary outcome (e.g., the project is completed by a specific date)?
  - The Expected Value Method: Is the variable consideration based on a range of outcomes (e.g., incentives based on costs compared to target)?
  - Must apply one method throughout the contract
- Consider the following factors in assessing whether the estimated transaction price is subject to significant revenue reversal:
  - Highly susceptible to factors outside entity’s influence
  - Uncertainty not expected to be resolved for a long time
  - Entity’s experience is limited
  - Entity typically offers broad range of price concessions/payment terms
  - Large number of broad range possible outcomes

Internal controls

Internal controls

Controls over the implementation of the new standard need to be part of a Company's control framework. Controls may include:

Scope	Control
Evaluation of impact	• Accounting whitepapers are prepared and reviewed by appropriate levels of management including consideration of the relevant guidance and applicability to the Company's contracts. • A review is performed over the analysis or reconciliation prepared to identify a complete population of contracts or policies that may be impacted by the new revenue recognition standard. • When a portfolio or profiling approach is used to "profile" the contracts that require further evaluation (see checklist control below), a review of the profiling is performed to ensure that the buckets/categories are reasonable. • A revenue recognition checklist is prepared and reviewed to identify relevant contractual terms and conditions to assess the impact of the new revenue standard. Information or data used in the preparation of checklists are reviewed and approved. • Disclosures are reviewed for consistency and completeness with ASC 606
Calculation of adjustment (use of system)	• Change management controls over the relevant system • Manual inputs made to contract information in the system (e.g. performance obligations, revenue recognition method, etc.) are reviewed • Changes to the estimates at completion to reflect new performance obligations are reviewed for accuracy and completeness • Cumulative adjustment generated by the system is reviewed.
Calculation of adjustment (manual)	• The spreadsheets used to develop the adjustment are subject to design and access controls. • All dual accounting entries are reviewed based on supporting documentation and reviewed by management. • Reconciliations of accounts impacted by dual accounting are prepared each quarter and reviewed by management • If dual accounting is utilized there are additional controls around pulling reports to make sure that accounts are only pulled related to the correct accounting method.

Internal controls

Sample Considerations for Controls in the Sustained Control Environment

Scope	Control
Alignment with accounting standard and revised processes	• Controls will need to be developed or modified to align with the new processes placed into action to address the ongoing application of the new revenue standard. • Controls will need to be developed to monitor the ongoing applicability of any assumptions, such as project profiles, used in the application of the revenue standard. • Disclosures are reviewed for consistency and completeness with ASC 606
Training of control owners	• Controls related to assessment of the knowledge and training of control owners under the revenue standard will need to be considered.

Disclosures

Disclosures

Overview – Annual requirements

Annual disclosures (ASC 606)

Disclosures about contracts with customers

- Disaggregation of revenue
- Information about contract balances
- Information about performance obligations
- Remaining performance obligations

Disclosures about significant judgments and estimates

- Description of significant judgments
- Transaction price, allocation methods and assumptions

Other required disclosures

- Practical Expedients
- Contract costs

Disclosures

Overview – Interim requirements

Interim disclosures (ASC 606)*

Disclosures about contracts with customers

- **Disaggregation of revenue**
- **Information about contract balances**
- **Information about performance obligations**
- ~~Remaining performance obligations~~

Disclosures about significant judgments and estimates

- ~~Description of significant judgments~~
- ~~Transaction price, allocation methods and assumptions~~

Other required disclosures

- ~~Practical Expedients~~
- ~~Contract costs~~

Interim only disclosures

- ASC 270, *Interim Reporting*
- IAS 34, *Interim Financial Reporting*

***Refer S-X Article 10 regarding interim disclosure requirements in initial year of adoption.**

Implementation considerations

Implementation challenges

- Joint Ventures
  - Complexity
  - Cleaning up old GAAP inconsistencies while implementing new standard
- Public-Private Partnership
  - Significant change in accounting
  - Very long-term contracts
  - No automated solution
- Impact of termination provision on accounting and disclosure
- Additional extensive disclosure requirements
  - Backlog vs. Remaining Unsatisfied Performance Obligations
  - Information about significant changes in contract asset and liability balances

Implementation requires a cross-functional team effort

Accounting

- Identification of revenue streams and assessment of potential impacts within each revenue stream
- Updating accounting policies and revenue processing procedures
- Training for team members on the future state of revenue accounting and data retention from now through Q1 2018
- Updated accounting procedures should be implemented for the key areas with changes in the new standard

Information Technology Systems

- Potential impacts to legacy revenue recognition systems and sub-ledgers
- Work with accounting to identify updates to systems requirements
- Systems will have to be updated to capture information about contracts with customers in a systematic way in order to comply with extensive disclosure requirements

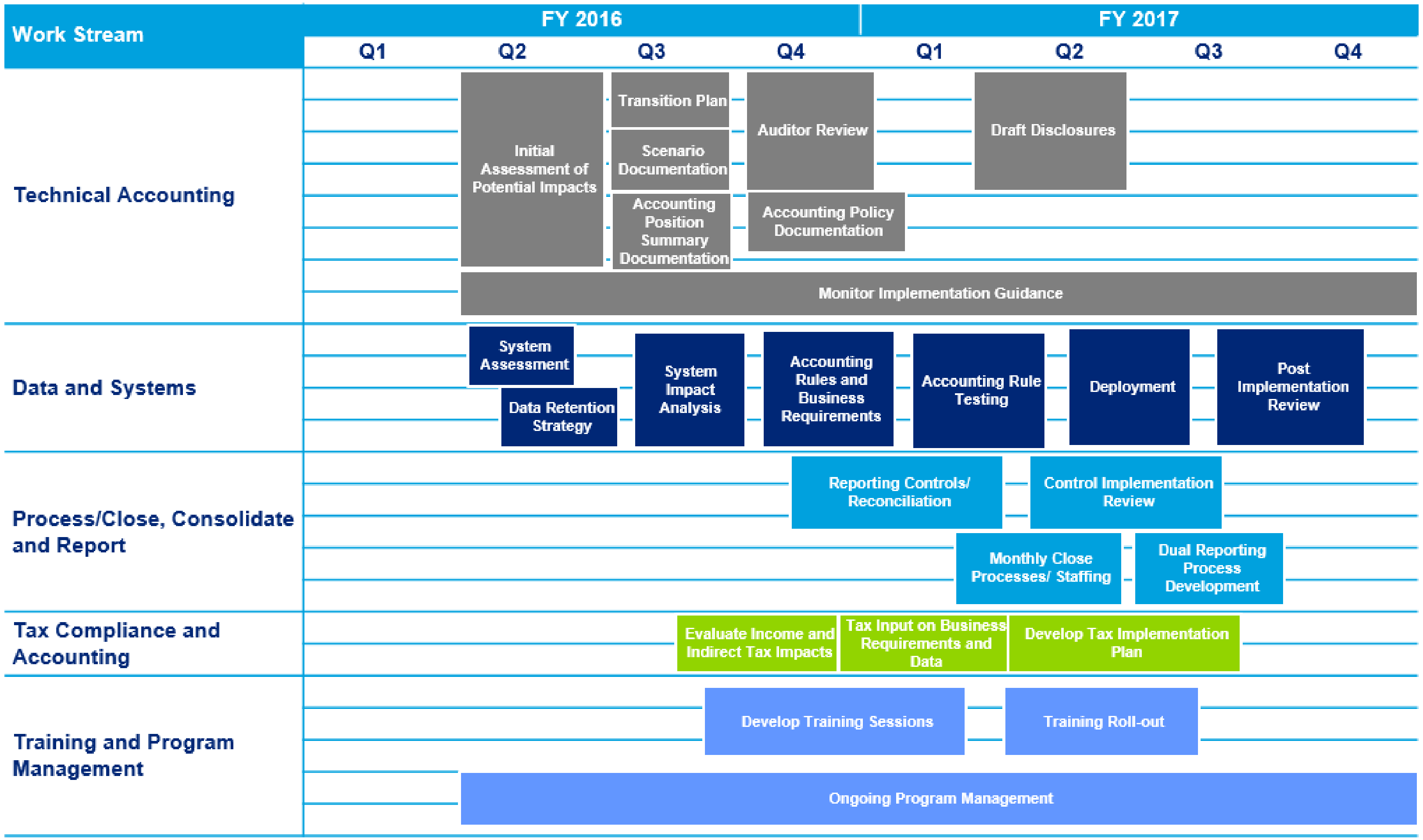
Operations

- Team members will need to support the accounting team in their understanding of the operational aspects of various revenue streams
- Participate in initial assessment and follow-up working sessions to share insight on business practices that may or may not be captured within written contracts
- Maintain open communication with accounting to identify any unique arrangements in sales contracts that may impact revenue recognition

Program Management

- Work with teams to develop integrated plan, identify inter-dependencies and track progress against the plan
- Coordination of activities and efforts across work streams
- Identify and elevate issues requiring executive input and coordinate the process for issue resolution

Illustrative activities and roadmap for implementation



Leveraging technology to navigate the road to implementation

Reviewing contracts with customers is a critical component of an assessment phase and can be a time consuming process due to the length and complexity of contracts. Certain technologies can perform contract analysis through predefined values and metrics, thereby reducing the amount of manpower required to perform contract reviews.

Maintaining an up to date contract database is required in order to provide real-time contract information required for analysis under the new standard. A contract database should be readily accessible by multiple users of the organization to view, analyze, and update portfolios of contracts under the new revenue standard.

Efficient program management is essential to implementing the new revenue standard. Risk management and communication of progress and issues should be communicated to stakeholders of the organization in real-time. Utilizing technology that can streamline the program management office is key to an effective implementation of the new revenue standard.

Information technology

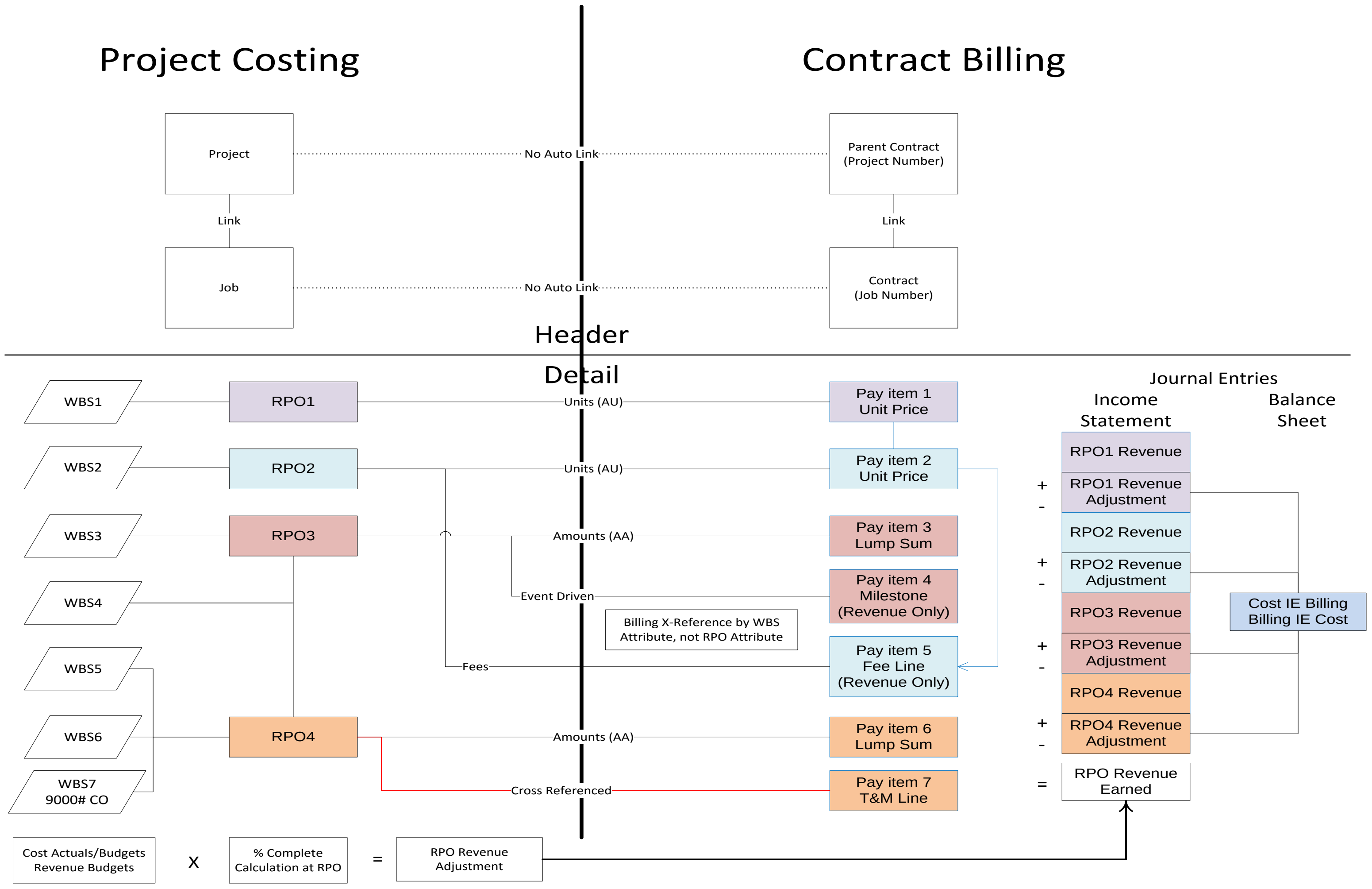
Opportunities for improvement

When companies prepare for system changes they often find benefits in reviewing business process and standardization. Master data management and work breakdown structure standardization play important roles in enhancing reporting and analysis.

Opportunity	Benefit
Master Data Management (MDM)	Master data management allows companies to take full advantage of system integrations and single point of entry.
Work Breakdown Structure (WBS)	Standard WBS allows companies to compare like work to support analytics and plan and budget for future projects.
Project Attributes	Adding project attributes to master data supports a more robust reporting and analytics platform.
Project Billing	System billing links project work to associated revenue to the project work in Accounts Receivable.
Cross-Reference between WBS and Billing	The WBS and billing connection allows for more automated billing based on quantities and % complete and the proper link to AR and GL.
Cross-Reference between WBS and Revenue Performance Obligation (RPO)	The WBS and RPO connection enables the calculation of earned revenue by RPO.

How should systems handle the standard?

How do the building blocks of WBS, RPO, % Complete, Billing (Revenue) and GL fit together from a system perspective.



Tax

Revenue recognition for tax — Generally

Long Term Construction Contracts

- Tax methods of “percentage of completion” differ from GAAP
  - Expenses for tax generally lag GAAP (compensation accruals, reserves, etc.)
  - Results in deferral for tax purposes
  - Analysis to determine expense allocation method on project by project basis.

Non-Long Term Construction Contracts (i.e. pure engineering / services)

- Revenue is recognized for tax purposes when substantially “all events” have occurred to earn the revenue
- Opportunities to defer revenue for tax purposes:
  - Retainage
  - Award Fees
  - Holdback

Revenue recognition — Non-Construction

Costs in Excess of Billings

- Under an accrual method of accounting, income must be recognized when:
  - All the events have occurred that fix the right to receive such income; and
  - The amount thereof can be determined with reasonable accuracy.
- All the events that fix the right to receive income occur when the first of the following take place:
  - Required performance takes place;
  - Payment is due; or
  - Payment is made.
- There is no authority for requiring the accrual of income upon partial performance of a contract prior to an agreed payment date or payment being received.
- Opportunity may exist for taxpayers to defer revenue associated with income for which the all-events test has not been met.

Special Consideration for Advanced Payments for Non-Construction

Billings in Excess of Cost (pre-bill)

- Not includible in taxable income until earned BUT
- MUST be included in taxable income no later than subsequent tax year per Revenue Ruling 2004-34
  - May result in accelerated revenue recognition for tax purposes compared to GAAP

Interplay with Retainage / Award Fees / Holdback

- Revenues cannot be deferred if they are not yet included in income
- Accounting method considerations
- Contract by contract analysis for those which have BOTH a pre-bill component AND retainage, award fees, holdback, etc.

Other tax considerations

- Simplified cost to cost method
- Year of substantial completion – 95%
- 10% method
- Look back calculation
- Variable consideration price – included for GAAP – maybe not for tax
- Bid and proposal costs

Introduction

Key points — Adoption of ASC 606 / IFRS 15

Overall Tax Impacts

Will result in numerous tax impacts from both a technical and systems standpoint

Opportunity

Take a fresh look at the tax accounting methods available. Implement with method changes already required to be filed as a result of ASC 606.

IRS Expectations

The Internal Revenue Service understands that the adoption of the new revenue recognition standards will have federal income tax implications and expects companies to perform the requisite procedures in order to address these implications

System Impacts

Companies may need to capture data differently and suitable to accommodate BOTH ASC 606 and Tax

Cash Tax Impact

The new revenue recognition standards may result in different revenue recognition for tax purposes as compared to GAAP

The Five-Step Model – E&C Considerations

- Unpriced change order
- Undefinitized contract
- Unfunded amounts

- Award fees
- Incentive fees

- Fixed and determinable
- IRC 460 considerations

Identify the contract with the customer (Step 1)

Identify the performance obligations in the contract (Step 2)

Determine the transaction price (Step 3)

Allocate the transaction price to the performanc e obligations (Step 4)

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

- Renewal options

- Form of contract and contract price
- Engineering vs. construction

Elements of the new GAAP standard (may or may not be allowable for Tax)

Elements allowable under 460	Elements NOT allowable under 460
• Identification of a contract • Change orders • Performance obligation satisfaction over time	• Identification of a contract – may be required "sever or aggregate" contract • Change orders – different distinctions • Performance obligation satisfaction at a point in time • Bid and proposal costs

Identifying contracts — Tax

The tax rules for severing or aggregating contracts rely on three factors – Treasury Regulation 1.460-1(e)

1. Independent pricing of terms
2. Separate delivery or acceptance
3. Reasonable business person:
   a. would not have entered into one of the agreements for the terms agreed upon without also entering into the other agreement(s) or
   b. would not have entered into separate agreements containing terms allocable to each severed contract.

Applies to contracts and change orders

Common tax considerations and anticipated action items

Areas of impact:

Area	Common tax considerations	Anticipated action items
GAAP Revenue Recognition	• Current types of revenue streams and related GAAP treatment • Assess how the GAAP change in method of accounting under the new standards for each of the various revenue streams will impact the current tax method	• Opportunity to leverage financial statement revenue stream analysis to proactively generate additional cash and fund project implementation costs
Tax Provision	• Any changes to tax accounting methods or book tax difference computations must be incorporated into the tax provision process • Consideration should be given to the correct period to reflect the change	• Computation and tracking of new or altered book-tax differences
Tax Accounting Methods	• Changes to revenue recognition will impact some combination of: – the amount of book-tax differences, – a change in the calculation of existing book-tax differences, – creation of a new book-tax difference, or – require a tax accounting method change • Timing and impact of method changes must be considered (automatic vs. non-automatic, and IRC § 481 adjustment calculation) • Enactment of tax reform could convert the timing benefits to permanent benefits thereby increasing the power of tax planning	• Requests for changes in tax method of accounting • Identifying the most advantageous tax method for certain items impacted by the new standards during adoption can reduce the overall unfavorable tax impact (e.g., changing to recognize unbilled revenue upon the earlier of payment becoming due or performance occurring and to deduct contract costs as incurred)

Common Tax Considerations and Anticipated Action Items (cont.)

Areas of impact:

Area	Common tax considerations	Anticipated action items
Tax Data and Process/Systems	• Systems will need to be evaluated to confirm that the software solutions used by accounting will provide the necessary data for tax analysis • Identify additional data needed to support tax accounting	• Reconciliation of the book restatement with tax's lack thereof and associated tracking considerations
Indirect and MultistateTax	• Sales tax, VAT, telecom taxes, fuel taxes, etc. • Impact to indirect tax varies greatly by industry and type of taxes imposed. • Impacts generally expected in areas where the basis of tax is book revenue or where the tax base is not well defined • Changes to the basis of tax could impact the amount of tax reported as well as collections. In some instances, there may be a disconnect between the basis on which a company collects and the base on which it remits to the taxing authorities (e.g., telecom taxes imposed on book revenue but collected on billings to the customer which may not change due to the adoption process) • Many tax types are based upon billed revenues, which underlies the importance of reducing changes to the billing systems	• Indirect tax reporting • Multistate allocation and apportionment
Global Tax Implications	• Any changes to the statutory financial statements can potentially impact tax measures based upon the financial statements, such as: thin capitalization limits, distributable reserves and transfer pricing • Since both IFRS and US GAAP are changing, cash taxes may be impacted in local countries due to changes in statutory financial statements. For jurisdictions similar to the US, tax methods may need to be reviewed. For jurisdictions where the statutory filings form the basis of tax with few modifications, cash taxes paid to the jurisdiction may be impacted	• Thin capitalization limits, distributable reserves, foreign tax credits and transfer pricing

Case study

Case study facts

- Company ABC has been contracted to construct a bridge
- Construction is expected to last 3 years
- Scope of work includes
  - Remediation of existing site
  - Engineering
  - Construction
  - Procurement
  - O&M
- The contract includes an award fee
- There are advanced payments under the contract

Case study discussion

- Differences in accounting under ASC 605-35 and ASC 606
  - Performance obligations
  - Allocation of contract value
  - Award fee
  - Multi-year contract/consideration of transition method
- Tax consequences of new guidance
- Systems consequences of new guidance
  - Multiple performance obligations
  - Cross references to WBS for % complete and contract for revenue
  - Changes to COA based on new accounting entries
  - Automation of the process

Q&A

Deloitte.

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