Revenue Recognition: FASB’s New Standard Is No Longer Near — It’s Here
2017 Engineering and Construction Conference
Overview
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.

1. **Identify the contract with a customer** (Step 1)
2. **Identify the performance obligations in the contract** (Step 2)
3. **Determine the transaction price** (Step 3)
4. **Allocate the transaction price to performance obligations** (Step 4)
5. **Recognize revenue when (or as) the entity satisfies a performance obligation** (Step 5)

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**

Identify all (explicit or implicit) promised goods and services in the contract

Are promised goods and services distinct from other goods and services in the contract?

**Capable of being distinct**
Can the customer benefit from the good or service on its own or together with other readily available resources?

**Distinct within context of the contract**
Is the good or service separately identifiable from other promises in the contract?

**YES**
Account for as a performance obligation

**NO**
Combine two or more promised goods or services and reevaluate
Distinct goods or services

- Clarifies the meaning of a promise that is separately identifiable (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)
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.
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:

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<th>Scope</th>
<th>Control</th>
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| **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

<table>
<thead>
<tr>
<th>Scope</th>
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| **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**
- **Practical Expedients**
- **Contract costs**

#### Other required disclosures
## Disclosures

### Overview – Interim requirements

#### Interim disclosures (ASC 606)*

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<tr>
<th>Disclosures about contracts with customers</th>
<th>Interim only disclosures</th>
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<tbody>
<tr>
<td>Disaggregation of revenue</td>
<td>ASC 270, Interim Reporting</td>
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<tr>
<td>Information about contract balances</td>
<td>IAS 34, Interim Financial Reporting</td>
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<td>Information about performance obligations</td>
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<td>Remaining performance obligations</td>
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<tr>
<th>Disclosures about significant judgments and estimates</th>
<th>Other required disclosures</th>
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<tr>
<td>Description of significant judgments</td>
<td>Transaction price, allocation methods and assumptions</td>
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<td>Practical Expenditures</td>
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<td>Contract costs</td>
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*Refer S-X Article 10 regarding interim disclosure requirements in initial year of adoption.*
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

<table>
<thead>
<tr>
<th>Work Stream</th>
<th>FY 2016</th>
<th>FY 2017</th>
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<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
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<tr>
<td>Technical Accounting</td>
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<td>Initial Assessment of Potential</td>
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<td>Impacts</td>
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<td>Transition Planning</td>
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<td>Scenario Documentation</td>
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<td>Accounting Position, Summary</td>
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<td>Documentation</td>
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<td>Monitor Implementation Guidance</td>
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<td>Data and Systems</td>
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<td>System Assessment</td>
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<td>Data Retention Strategy</td>
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<td>System Impact Analysis</td>
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<td>Accounting and Business</td>
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<td>Requirements</td>
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<td>Accounting Rate Testing</td>
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<td>Deployment</td>
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<td>Post Implementation Review</td>
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<td>Process/Close, Consolidate</td>
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<td>and Report</td>
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<td>Reporting Controls/ Reconciliation</td>
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<td>Control Implementation Review</td>
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<td>Monthly Close</td>
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<td>Process/Staffing</td>
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<td>Dual Reporting Process Development</td>
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<td>Tax Compliance and Accounting</td>
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<td>Evaluate Income and Indirect Tax</td>
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<td>Impacts</td>
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<td>Tax Input on Business</td>
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<td>Requirements and Data</td>
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<td>Develop Tax Implementation Plan</td>
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<td>Training and Program Management</td>
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<td>Develop Training Sessions</td>
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<td>Training Roll-out</td>
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<td>Ongoing Program Management</td>
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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
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.

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

**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.

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

**Overall Tax Impacts**
Will result in numerous tax impacts from both a technical and systems standpoint

**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

**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

- Identify the contract with the customer (Step 1)
  - Unpriced change order
  - Undefinitized contract
  - Unfunded amounts

- Identify the performance obligations in the contract (Step 2)
  - Award fees
  - Incentive fees

- Determine the transaction price (Step 3)
  - Fixed and determinable
  - IRC 460 considerations

- Allocate the transaction price to the performance obligations (Step 4)
  - Renewal options
  - Form of contract and contract price
  - Engineering vs. construction

- Recognize revenue when (or as) the entity satisfies a performance obligation (Step 5)
Elements of the new GAAP standard (may or may not be allowable for Tax)

<table>
<thead>
<tr>
<th>Elements allowable under 460</th>
<th>Elements NOT allowable under 460</th>
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<tbody>
<tr>
<td>• Identification of a contract</td>
<td>• Identification of a contract – may be required</td>
</tr>
<tr>
<td>• Change orders</td>
<td>&quot;sever or aggregate” contract</td>
</tr>
<tr>
<td>• Performance obligation satisfaction over time</td>
<td>• Change orders – different distinctions</td>
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<td>• Performance obligation satisfaction at a point in time</td>
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<td>• Bid and proposal costs</td>
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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:

<table>
<thead>
<tr>
<th>Area</th>
<th>Common tax considerations</th>
<th>Anticipated action items</th>
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</table>
| **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:

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<th>Anticipated action items</th>
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</table>
| **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 Multistate Tax**           | - 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