Contractors' financial statements to change in 2019

By Rich Shavell, CPA, CVA, CCIFP
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How contractors report revenue is changing, and all commercial contractors will need to be ready if they supply GAAP based financial statements for their bank, surety, or for governmental prequalification programs. These new rules impact contractors' 2019 financials.

Overview

In May 2014 the Financial Accounting Standards Board (FASB) released Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606). Five years later it is now time for non-public contractors to implement the changes.

For more than a decade the FASB has worked to develop a principles-based model for recognizing revenue. The business community, including the Construction Industry, was told that the objective is to improve consistency, comparability of revenue recognition practices, and usefulness of disclosures. Whether such an objective will be achieved is not yet clear.

In addition to public companies, these changes apply to non-public companies if they report under Generally Accepted Accounting Principles (GAAP). It is this GAAP framework that credit grantors such as banks and sureties typically require for a contractor's annual reporting.

Rumors & Myths

Here are a few of the issues and concerns contractors have been sharing with us.

PCM - Is the percentage of completion method (PCM) really gone? The PCM that the construction industry has used for the last almost forty years is technically eliminated. Importantly, the methodology is maintained within the new Standard but with several changes.

Performance obligations - One contractor tells us he heard that all contracts were going to have to be segmented into multiple "performance obligations." It is true that the unit of measurement for accounting has shifted from the total contract to the performance obligation(s). But the reality is that for the typical commercial contractor, after they evaluate their contracts they will find that at contract commencement most will be reported as a single performance obligation. That is not to say all contracts will not have multiple performance obligations.

Income acceleration - An astute CFO wanted to clarify with us his understanding thathe may be able to accelerate income in certain situations. This is true for certain circumstances. For example, under the new Standard gross profit can be recognized on unpriced change orders. Contractors, under specific circumstances, may be permitted - unlike today - to recognize gross margin on an unpriced change order before the change order is signed.

Supportive documentation for decision making - Another contractor concluded that the new Standard seems to call for "a lot of speculation." The standard does require more "judgement calls" and estimates by the contractor. For those contractors who supply audited statements, not only are these estimates and judgments required but the contractor will need to maintain sufficient documentation so their auditors can "test" the underlying decision-making process.

Effective Dates and Transition

For nonpublic companies, the standard is effective for calendar year 2019 and interim reporting periods, i.e. each quarter starting in 2020. Nonpublic companies may elect early adoption starting with calendar 2018, which is not likely.

For the 2019 initial transition year, contractors have two choices:

- Restate prior periods: If comparative statements are prepared reflecting both 2018 and 2019 results then the 2018 results will need to be restated based on the new Standard; or
- Prospectively: Implement the change for all contracts already in progress at the beginning of 2019 and all new contracts entered into during 2019.

FIVE STEPS OF THE NEW REVENUE RECOGNITION MODEL

The core principle of the new model is:

- The contractor recognizes revenue as it transfers goods or services to customers in an amount reflecting the consideration it expects to receive. A five-step model achieves this core principle.

Step 1: Identify the Contract with a Customer

The first step is identifying the contract, which is defined as "an agreement between two or more parties that creates enforceable rights and obligations." For commercial contractors identifying contracts is something that is fairly basic and should not be an issue.

Step 2: Identify the Performance Obligations in the Contract

Next determine if there are multiple performance obligations within the contract. A performance obligation is "a promise in a contract with a customer to transfer a good or service to a customer." The contractor will use specified criteria and significant judgment to distinguish and identify "distinct" bundle(s) of promises within the contract representing the performance obligation(s) and also how these obligations are satisfied.

Step 3: Determine the Transaction Price

The transaction price is the amount a contractor expects to be entitled for transferring goods or services under the contract. In addition to the basic contract terms, to determine the transaction price, the contractor construes several areas including "variable consideration."

Variable consideration is revenue that can vary such as incentives, performance bonuses, penalties, discounts, rebates, refunds, credits, price concessions, or other similar items.

Depending on circumstances, variable consideration is only included in the transaction price to the extent it is probable that a significant revenue reversal will not occur. This "constraint" on revenue is a new concept that requires estimation and judgement.

Step 4: Allocate the Transaction Price to the Performance Obligations in the Contract

The transaction price after adjustments for variable consideration is allocated to all performance obligations (determined under Step Two) based on their relative standalone selling price ("SSP"). This SSP is another new concept. For example, if a contractor has a contract with two performance obligations (example: original contract and a significant change order) then the transaction price is allocated among the two performance obligations.

The Standard states that an observable price at which the entity normally separately sells the good or service is the best evidence of the SSP. In most cases, because of the unique nature of the work for each respective construction contract we can expect that estimates - based on for example, a cost-plus basis - will likely be utilized by the contractor to determine the requisite SSPs.

Step 5: Recognize Revenue When (or As) the Entity Satisfies a Performance Obligation

The new Standard functions under the premise that revenue should be recognized when (or as) control of a good or service is transferred to a customer. For the contractor this is generally "as the work is performed" for which the contractor is entitled to progress payments. This step generally mirrors the current PCM methodology - but with several changes.

Footnote Disclosures

The new footnote disclosure requirements are expanded and include new quantitative and qualitative information regarding the amount, timing, and uncertainty of revenue from contracts with customers and the significant judgments contractors utilize in their financial statements. Non-public companies are permitted certain "shortcuts" and are not required to include several of the more onerous disclosures.

Summary

The new reporting Standard requires more estimates and "judgement calls" by the commercial contractor. If you require a GAAP statement for surety, banking, or prequalification with government agencies, you'll need to address the transition for reporting under the new Standard so you can be ready when your outside CPAs or auditors arrive to review or audit your 2019 financial statements.

Rich Shavell has spent the last 30 years serving the commercial construction industry and all types of contractors. Shavell & Company, P.A. is a Florida based full-service certified public accounting and consulting firm offering a comprehensive array of tax and accounting services for businesses of all sizes. Shavell & Company helps contractors with bonding maximization, tax structuring and planning, litigation support, business valuation, cash flow analysis, and cost segregation studies. He has testified six times before Congress and five times before the IRS on legislation and proposed regulations impacting the Construction Industry. Mr. Shavell is a four-time winner of the South Florida Business Journal awards for accountants in construction, real estate, and tax categories.

Shavell & Company, P.A. may be reached at www.shavell.net or 561-997-7242