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Background & Summary

The deadline for adoption of the new revenue recognition guidance has arrived for public entities\(^1\) and is fast approaching for all other entities. This new model supersedes industry-specific guidance and substantially all existing revenue recognition guidance and adds significant interim and annual disclosures. The effect on each construction company will vary depending on existing revenue streams, accounting policy elections and estimation methodologies. Even if the timing of revenue recognition does not change, policies, internal controls and management’s significant judgments will need to be documented or updated to reflect the new guidance (see Appendix A for additional internal controls that may be needed). Companies that have already adopted the new standard have found that implementation took more time and effort than expected.

Shortly after the revenue standard’s release, the Financial Accounting Standards Board (FASB) formed the Joint Transition Resource Group (TRG) for Revenue Recognition to aid transition to the new standard by soliciting, analyzing and discussing stakeholder issues arising from implementation of the new guidance. While the TRG members’ views are nonauthoritative, contractors should consider them as they implement the new standards.

This industry-specific supplement to our comprehensive white paper highlights the changes from current accounting and the areas most likely to present implementation challenges for the construction industry. This paper focuses on those items in Accounting Standards Codification (ASC) 606 that will have the greatest effect on construction companies and includes all subsequent amendments, TRG clarifications, finalized and exposed guidance from the American Institute of CPAs Engineering & Construction Contractors Revenue Recognition Task Force (Task Force) and U.S. Securities and Exchange Commission (SEC) views gathered from official speeches. The paper also includes excerpts from large accelerated filers that were required to adopt the standard in the first quarter of 2018.

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\(^1\) *The new revenue standard defines a public entity as any one of these:*

- A public business entity
- An NFP entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC
Scope
The new revenue standard applies to all contracts with customers, except for those within the scope of other standards, e.g., lease contracts, insurance contracts, financing arrangements, financial instruments, guarantees (other than product or service warranties) and certain nonmonetary exchanges between vendors. A contract may be partially in the scope of the new standard and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, an entity should apply those requirements first before applying ASC 606.

The Revenue Recognition Model
The model’s core principle is that an entity would recognize revenue in the amount that reflects the consideration to which it expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, an entity would apply a five-step model:

- Identify the contract(s) with a customer
- Identify performance obligations
- Determine the transaction price
- Allocate the transaction price to performance obligations
- Recognize revenue when (or as) a performance obligation is satisfied
Step 1 – Identify the Contract with a Customer

A contract is defined as “an agreement between two or more parties that creates enforceable rights and obligations” and meets all of the following criteria:

- Approved by all parties to the contract – this approval can be written, verbal or implied by an entity’s customary business practices. Both parties must be committed to satisfying their respective performance obligations.
- Contains identifiable rights, obligations and payment terms for each party to the contract.
- Has commercial substance, defined as the expectation that the entity’s future cash flows will change as a result of the contract.
- Collectibility is probable, i.e., it is probable the entity will collect the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer.

A contract would not exist if each party has the unilateral enforceable right to terminate a wholly unperformed contract without compensation.

Revenue will not be recognized for a contract that fails to meet all the criteria above until either:

- The entity has no remaining obligations to transfer goods or services to the customer and all—or substantially all—of the consideration promised by the customer has been received by the entity and is nonrefundable.
- The contract has been terminated and the consideration received from the customer is nonrefundable.
Unpriced Change Orders

Frequently, contractors and customers agree to changes in the scope of work, though the amount of consideration is not determined for a period of time. FASB clarified in its Basis for Conclusions that lacking identification of payment terms in a contract would not preclude revenue recognition if the scope of work has been approved and the entity expects the price will be approved. In these situations, an entity should estimate the change to the contract price as variable consideration. See “Step 3 – Determine the Transaction Price” for variable consideration.

Collectibility

Collectibility is an explicit threshold that must be assessed before applying the new revenue recognition model to a contract. An entity must evaluate customer credit risk and conclude it is “probable” that it will collect the amount of consideration due in exchange for the goods or services. The assessment is based on the customer’s ability and intent to pay as amounts become due. An entity only will consider credit risk and no other uncertainties, such as performance or measurement, as these are accounted for separately when determining timing and measurement of revenue. Any subsequent negative adjustments related to customer credit risk will be recognized as an expense in the income statement and measured in accordance with the financial instrument standard.

ASU 2016-12 clarifies that the collectibility assessment is not based on collecting all the consideration promised in the contract. Instead, entities should consider the probability of collecting the consideration they will be entitled to in exchange for the goods or services they will transfer to the customer. An entity should take into account its ability to demand advance payments from customers or stop providing goods or services if the customer stops paying consideration when it is due.

Recognition – Contract Criteria Not Met

The original standard only allowed two situations in which revenue could be recognized if an arrangement did not meet all five criteria to be considered a contract. ASU 2016-12 adds a third option for revenue recognition. Revenue can be recognized when the amount an entity receives from the customer is nonrefundable and one of the following events has occurred:

- The entity has no obligation to transfer additional goods or services and substantially all of the consideration has been received.
- The contract has been terminated.
- The entity has transferred control of the goods or services related to the received consideration, and the entity has stopped transferring and has no obligation to transfer additional goods and services to the customer.

Contract Termination

ASU 2016-12 clarifies the definition of “contract termination,” which means an entity is allowed to stop (based on contract terms or by law) and has stopped transferring goods or services to the customer. The contract does not need to be legally terminated and the entity does not need to stop pursuing collection from the customer for the contract to be considered terminated for purposes of recognizing the cash collected as revenue.

Combining Contracts

Under current industry guidance, combining contracts is permitted—but not required—if certain criteria are met. Under ASC 606, contracts will be required to be combined when certain criteria are met. While the language in the new revenue standard is different, it should not result in a substantial change in the assessment of whether contracts should be combined.
Combining Contracts

<table>
<thead>
<tr>
<th>Current U.S. Generally Accepted Accounting Principles (GAAP)</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts may be combined if they:</td>
<td>Contracts entered into at or near the same time with the same customer (or related parties) must be combined if one or more of the following criteria are met:</td>
</tr>
<tr>
<td>• Were negotiated together with an overall profit margin objective</td>
<td>• Contracts are negotiated together with a single commercial objective</td>
</tr>
<tr>
<td>• Constitute an agreement for a single project</td>
<td>• Pricing interdependencies exist between contracts</td>
</tr>
<tr>
<td>• Require closely interrelated construction activities with substantial common costs that cannot be separately identified with or reasonably allocated to the elements, phases or unit of output</td>
<td>• Goods or services in the contracts represent a single performance obligation (see “Step 2 – Identify Performance Obligations”)</td>
</tr>
<tr>
<td>• Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity</td>
<td></td>
</tr>
<tr>
<td>• Constitue an agreement with a single customer</td>
<td></td>
</tr>
</tbody>
</table>

Combining contracts is permitted but not required if the underlying economics of the transaction are fairly reflected.

SEC Observation – The combination guidance in ASC 606 explicitly limits what contracts may be combined to those with the same customer or related parties of the customer. SEC staff objected to extending the contract combination guidance beyond those parties even though other criteria for combination were met.

Contract Modifications

A contract modification occurs when the parties to a contract approve a change in the scope or price of a contract that creates new enforceable rights and obligations or changes existing ones. Previous revenue guidance did not include a framework for accounting for contract modifications, except for construction and production-type contracts. Under ASC 606, a contract modification can be written, oral or implied by customary business practices. Contract claims, e.g., additional consideration for customer-caused delays, changes or errors in specifications, would be accounted for like contract modifications. Unsettled claims and unpriced change orders would be accounted for similar to modifications only if the scope of the work has been approved and the entity can estimate the change in transaction price. Entities should estimate the change in transaction price in accordance with the guidance on estimating variable consideration and constraint on revenue recognition (see “Step 3 – Determine the Transaction Price”). When an entity anticipates a claim being settled through adjudication or arbitration, the degree of uncertainty of the amount of consideration is likely to increase, causing a delay in revenue recognition until the uncertainty is resolved due to the variable consideration constraint.

Accounting for contract modifications will depend on the type of modification. A contract modification would be recognized as a separate contract only if distinct goods or services are added for additional consideration that reflects their standalone selling prices. If these two criteria are not met, the modification would be accounted for
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on a combined basis with the original contract, either prospectively or on a cumulative catch-up basis depending on whether the remaining goods or services are distinct from the goods or services transferred before the modification. If distinct, the modification is accounted for prospectively with the unrecognized consideration allocated to the remaining performance obligations and revenue recognized when (or as) the remaining performance obligations are satisfied. If the remaining goods or services are not distinct, the modification is accounted for as if it were part of the existing contract, forming part of a single partially satisfied performance obligation at the date of the modification. The modification’s effect on the transaction price and on progress toward satisfaction of the performance obligation is recognized as an adjustment to revenue on a cumulative catch-up basis.

Since almost every construction contract is unique, change orders will have to be evaluated to determine whether they are part of an existing performance obligation or if they represent a new performance obligation. If a contract modification is treated as a new contract, the revenue recognition pattern likely will be different than if combined with the original contract.

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Modifications</strong></td>
<td></td>
</tr>
<tr>
<td>Contract revenue and costs are adjusted for approved</td>
<td>Depending on the type of modification, either</td>
</tr>
<tr>
<td>scope and price modifications</td>
<td>considered a new contract or part of original</td>
</tr>
<tr>
<td></td>
<td>contract</td>
</tr>
<tr>
<td><strong>Unpriced Change Orders</strong></td>
<td></td>
</tr>
<tr>
<td>Included in revenue if recovery is probable and</td>
<td>If change in scope has been approved, the change in</td>
</tr>
<tr>
<td>amount can be reasonably estimated</td>
<td>transaction price should be estimated in accordance</td>
</tr>
<tr>
<td></td>
<td>with guidance on variable consideration. Variable</td>
</tr>
<tr>
<td></td>
<td>consideration should only be included in the</td>
</tr>
<tr>
<td></td>
<td>transaction price to the extent it is probable</td>
</tr>
<tr>
<td></td>
<td>that a significant reversal of cumulative revenue</td>
</tr>
<tr>
<td></td>
<td>recognized will not occur as a result of a change</td>
</tr>
<tr>
<td></td>
<td>in estimate of the consideration</td>
</tr>
<tr>
<td><strong>Claims Revenue</strong></td>
<td></td>
</tr>
<tr>
<td>Recorded when probable and estimable up to the</td>
<td>Included in the transaction price to the extent</td>
</tr>
<tr>
<td>extent of costs incurred. Profits are not recognized</td>
<td>it is probable that a significant reversal of</td>
</tr>
<tr>
<td>until realized</td>
<td>cumulative revenue recognized will not occur</td>
</tr>
<tr>
<td></td>
<td>when the uncertainty is resolved</td>
</tr>
</tbody>
</table>
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<table>
<thead>
<tr>
<th>Contract Modifications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of Modification</td>
</tr>
<tr>
<td>• Additional goods or services are distinct</td>
</tr>
<tr>
<td>• At standalone prices</td>
</tr>
<tr>
<td>• Remaining services are distinct</td>
</tr>
<tr>
<td>• Not at standalone prices</td>
</tr>
<tr>
<td>• Remaining services are not distinct</td>
</tr>
<tr>
<td>• Form part of a single partially complete performance obligation</td>
</tr>
</tbody>
</table>

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Our contracts are often modified through change orders to account for changes in the scope and price of the goods or services we are providing. Although the Company evaluates each change order to determine whether such modification creates a separate performance obligation, the majority of our change orders are for goods or services that are not distinct within the context of our original contract and therefore are not treated as separate performance obligations.

Pending change orders represent one of the most common forms of variable consideration included within contract value and typically represent contract modifications for which a change in scope has been authorized or acknowledged by our customer, but the final adjustment to contract price is yet to be negotiated. In estimating the transaction price for pending change orders, the Company considers all relevant facts, including documented correspondence with the customer regarding acknowledgment and/or agreement with the modification, as well as historical experience with the customer or similar contractual circumstances. Based upon this assessment, the Company estimates the transaction price, including whether the variable consideration constraint should be applied.

**Step 2 – Identify Performance Obligations**

Once an entity has identified a contract, it would identify separate performance obligations within that contract. A performance obligation is a promise to transfer a distinct good or service—or a series of distinct goods or services that are substantially the same and have the same pattern of transfer—to a customer. To be distinct, a promised good or service must be both:

- Capable of being distinct, *i.e.*, the customer can benefit from the good or service on its own or with other resources that are readily available to the customer
- Distinct within the context of the contract, *i.e.*, the good or service is separately identifiable from other promises in the contract. The following indicators would be used to evaluate if a good or service is distinct within the context of the contract:
  - Significant integration services are not provided
Revenue Recognition: Construction Industry Supplement

- The customer was able to purchase—or not purchase—the good or service without significantly affecting the other promised goods or services in the contract
- The good or service does not significantly modify or customize another good or service promised in the contract

An entity would determine whether the nature of its promise in the contract is to transfer each of the goods or services or whether the promise is to transfer a combined item (or items) to which the promised goods and/or services are inputs.

The promise can be explicitly identified in a contract or implied by customary business practices, published policies or specific statements. The notion of a performance obligation is similar to the notions of deliverables, components or elements of a contract in previous revenue guidance. This is a critical step, as the performance obligation—not the contract—is the unit of account for recognizing revenue under ASC 606.

Some goods and services may continue to be accounted for at the contract level, but in certain situations management may need to start separately accounting for multiple obligations within a contract.

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unit of Account</strong></td>
<td></td>
</tr>
<tr>
<td>Contract or segment</td>
<td>Performance obligation</td>
</tr>
<tr>
<td>A “profit center” is the unit of account for the measurement of revenues and costs. The profit center is usually a single contract, but under certain circumstances it may be a combination of two or more contracts, a segment of a contract or a group of combined contracts.</td>
<td>This is the promise to transfer distinct goods or services to a customer that can be explicitly identified in a contract or implied by customary business practices, published policies or specific statements.</td>
</tr>
</tbody>
</table>

Immaterial Items

FASB did not expect entities to identify significantly more performance obligations than the deliverables identified under current guidance. However, concerns arose, since the standard’s basis for conclusions noted the current SEC guidance on inconsequential or perfunctory items was intentionally not carried forward into ASU 2014-09. ASU 2016-10 permits entities to disregard promises that are deemed to be immaterial in the context of the contract. In addition, such items would not be required to be aggregated and assessed for materiality at the entity level for auditing purposes. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, an entity would accrue the related costs to transfer those goods or services.

This step has generated the most questions from contractors, since many interpreted the first discussion paper to mean an entity would need to account for every good or service transferred as a separate performance obligation, e.g., “every brick, every nail, every board.” As a result of industry feedback, the final standard provides clearer and more practical guidance on the identification of performance obligations.
For a building contractor, the materials used in a project, e.g., bricks, nails and boards, can be distinct; however, they are not distinct within the context of the contract and would not be accounted for as separate performance obligations, as doing so would not result in a faithful depiction of contract performance. Entities will need to exercise judgment and document their conclusions in evaluating separate performance obligations, e.g., a development contract that includes infrastructure and amenities. Because most construction contracts are highly integrated and customized, as highlighted in the example below, most—but not all—construction contracts likely would be a single performance obligation.

Example

An entity enters into a contract to design and build a hospital. The entity is responsible for the overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, construction of the structure, piping, wiring, installation of equipment and finishing. The entity would account for the bundle of goods and services as a single performance obligation because the goods or services in the bundle are highly interrelated and require the builder to provide significant integration, modification and customization in delivery of the hospital. Revenue from the performance obligation would be recognized over time by selecting an appropriate measure of progress toward complete satisfaction of the performance obligation.

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The decrease in retained earnings primarily resulted from a change in the manner in which the company determines the unit of account for its projects (i.e., performance obligations). Under the previous guidance, the company typically segmented revenue and margin recognition between the engineering and construction phases of its contracts. Upon adoption of ASC Topic 606, engineering and construction contracts are generally accounted for as a single unit of account (a single performance obligation), resulting in a more constant recognition of revenue and margin over the term of the contract.

Segmenting Contracts

The current industry guidance that permits segmenting contracts under certain circumstances was eliminated by the new standard. However, construction companies that segment contracts under current guidance might not be significantly affected due to the requirement to identify separate performance obligations.
Segmenting Contracts

If all the following criteria are properly documented, a contract can be segmented:

- Separate project components have bids distinct from the entire project
- Customer could accept the proposals on either basis
- Aggregate amounts of the separate proposals equaled the amount of the entire project proposal

Once the criteria are met, then each individual proposal becomes the unit of account for accumulating costs and recognizing revenue. The profit margin on each proposal may be different than the combined contract.

The following criteria must be met to separately account for performance obligations in a contract. The goods or services must be both:

- Capable of being distinct because the customer can benefit from the good or service on its own or with other resources that are readily available to the customer
- Distinct within the context of the contract – the good or service to the customer is separately identifiable from other promises in the contract

Warranties

Most warranties in the construction industry provide coverage against latent defects. Under ASC 606, entities must distinguish between warranties representing assurance of a product’s performance and those representing a separate performance obligation. If a customer has the option to separately purchase a warranty, the entity has promised to provide a service to the customer and would account for that warranty as a separate performance obligation. The transaction price would be allocated on a relative standalone selling-price basis. If no separate purchase option exists, the entity would apply the cost-accrual guidance in ASC 460, Guarantees. Therefore, the estimated costs related to an assurance-type warranty are excluded from the estimated total costs in the company’s measure of progress and accrued when or as the company transfers control of the goods or services to the customer. If an entity promises both assurance and service-type warranties but cannot reasonably account for them separately, then it would account for both together as a single performance obligation.

Warranties

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard warranty – liability is accrued when warranty costs are probable and reasonably estimable</td>
<td>Entities must distinguish warranties that represent assurance of a product’s performance from those that provide the customer with a service in addition to assurance; depending on the type of warranty, it may represent a separate performance obligation</td>
</tr>
<tr>
<td>Separately priced extended warranty – contractually stated price is deferred and recognized over the warranty period</td>
<td>Separately priced extended warranty – relative standalone selling price is deferred and recognized over the warranty period</td>
</tr>
</tbody>
</table>
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The company generally provides limited warranties for work performed under its engineering and construction contracts. The warranty periods typically extend for a limited duration following substantial completion of the company’s work on a project. Historically, warranty claims have not resulted in material costs incurred.

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In addition, when assessing performance obligations within a contract, the Company considers the warranty provisions included within such contract. To the extent the warranty terms provide the customer with an additional service, other than assurance that the promised good or service complies with agreed upon specifications, such warranty is accounted for as a separate performance obligation. In determining whether a warranty provides an additional service, the Company considers each warranty provision in comparison to warranty terms which are standard in the industry.

Step 3 – Determine the Transaction Price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties. The promised consideration may include fixed amounts, variable amounts or both. To determine the transaction price, an entity should analyze the terms of the contract and its customary business practices and consider the effects of the following:

- Variable consideration
- Constraining estimates of variable consideration
- The existence of a significant financing component in the contract
- Noncash consideration
- Consideration payable to a customer

Judgment will be required when applying these principles to the construction industry, especially when the contract price is variable. Revenue related to awards or incentive payments may be recognized earlier under the new standard in some situations.

Variable Consideration & Revenue Constraint

Variable consideration is anything that causes the amount of consideration to vary and may result from volume discounts, rebates, price concessions, refunds, performance bonuses, contingencies, royalties, penalties or other items. An entity should include in the transaction price an estimate of the amount of variable consideration to which it expects to be entitled, but only to the extent it is “probable” a significant reversal of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently
resolved. The level of confidence needs to be relatively high to recognize revenue for variable consideration. This is a qualitative assessment and not a quantitative threshold. This constraint also would apply to a fixed-price contract if an entity’s entitlement is contingent on the occurrence or nonoccurrence of a future event, e.g., performance bonuses or sales with a right of return. Management’s estimate of the transaction price will be reassessed each reporting period; the transaction price should be updated for any changes in circumstances throughout the period.

Significant judgment often will be needed to determine if the amount of cumulative revenue recognized is subject to a significant reversal. Entities should consider the following factors, which increase the likelihood or the magnitude of a revenue reversal:

- The amount of consideration is highly susceptible to factors outside of the entity’s influence.
- Resolution of the uncertainty about the amount of consideration is not expected for a long period of time.
- The entity has limited experience with similar types of contracts.
- The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions in similar circumstances for similar contracts.
- The contract has a large number and broad range of possible consideration amounts.

Entities are required to estimate the transaction price using either the “expected value” or the “most likely amount” approach, depending on which one is expected to most accurately predict the consideration to which the entity will be entitled:

- Expected value – used a probability-weighted estimate for a large number of contracts with similar characteristics
- Most likely amount – used when a contract only has two possible outcomes

An entity would use the same method throughout the life of the contract to update the estimated transaction price at each reporting date. TRG members clarified that the constraint on variable consideration should be applied at the contract level, as it is the unit of account for determining the transaction price.

**Currently for performance bonuses an entity would not include any amount until it is earned.** UnderASC 606, an entity would estimate and include in the transaction price the most predictive amount of a performance bonus that would not be subject to a risk of significant reversal. Some entities might recognize revenue earlier than current practice if they have predictive experience. If an entity does not have predictive experience relative to the entire transaction price, but does have predictive experience up to a certain amount or “floor,” the floor amount would be used in determining the transaction price.
Variable Consideration

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>The seller’s price must be fixed or determinable for revenue to be recognized (one of four recognition principles).</td>
<td>Variable consideration is included in the transaction price to the extent it is probable that a significant reversal of cumulative revenue will not occur.</td>
</tr>
<tr>
<td>Variable amounts are not included in the transaction price until the variability is resolved (except for percentage of completion method); the sales price in cancellable arrangements generally is not fixed or determinable until cancellation privileges lapse.</td>
<td>Estimates can be used if an entity has predictive experience.</td>
</tr>
</tbody>
</table>

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The nature of the company’s contracts gives rise to several types of variable consideration, including claims and unpriced change orders; awards and incentive fees; and liquidated damages and penalties. The company recognizes revenue for variable consideration when it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur. The company estimates the amount of revenue to be recognized on variable consideration using the expected value (i.e., the sum of a probability-weighted amount) or the most likely amount method, whichever is expected to better predict the amount. Factors considered in determining whether revenue associated with claims (including change orders in dispute and unapproved change orders in regard to both scope and price) should be recognized include the following: (a) the contract or other evidence provides a legal basis for the claim, (b) additional costs were caused by circumstances that were unforeseen at the contract date and not the result of deficiencies in the company’s performance, (c) claim-related costs are identifiable and considered reasonable in view of the work performed, and (d) evidence supporting the claim is objective and verifiable. If the requirements for recognizing revenue for claims or unapproved change orders are met, revenue is recorded only when the costs associated with the claims or unapproved change orders have been incurred. Back charges to suppliers or subcontractors are recognized as a reduction of cost when it is determined that recovery of such cost is probable and the amounts can be reliably estimated. Disputed back charges are recognized when the same requirements described above for claims accounting have been satisfied.

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Contract claims are another form of variable consideration which is common within our industry. Claim amounts represent revenue that has been recognized for contract modifications that are not submitted or are in dispute as to both scope and price. In estimating the transaction price for claims, the Company considers all relevant facts available. However, given the uncertainty surrounding claims, including the potential long-term nature of dispute resolution and the broad range of possible consideration amounts, there is an increased likelihood that any additional contract revenue associated with contract claims is constrained. The resolution of claims involves negotiations and, in certain cases, litigation. In the event litigation costs are incurred by us in connection with claims, such litigation costs are expensed as incurred, although we may seek to recover these costs.

Significant Financing Component

The construction industry typically has long-term contracts with various payment terms. Under the new standard, entities will need to assess the timing of customer payments in relation to the transfer of goods or services. A
difference in timing could indicate a significant financing component for either the customer or the entity for which the transaction price would need to be adjusted to reflect a selling price as though the customer had paid cash at the time of transfer.

To determine if a contract contains a significant financing component, an entity would consider all of the following:

- Whether the consideration would differ substantially if the customer paid cash promptly under the typical credit terms
- Expected length of time between delivery of goods or services and receipt of payment
- The interest rate in the contract and prevailing market interest rates

As a practical expedient, an entity would not reflect the time value of money if the period between customer payment and the transfer of goods or services is one year or less; this also would apply to contracts greater than one year. An entity must disclose if this practical expedient is elected.

The adjustment to the transaction price for the time value of money would use the discount rate implied in a separate financing transaction between the entity and the customer at contract inception, reflecting the borrower’s (customer’s) credit risk and any collateral or security provided. The rate may be calculated by discounting the nominal amount of the promised consideration to the cash selling price of the good or service. The rate cannot be adjusted for changes in circumstances or interest rates after contract inception.

The effects of financing would be presented separately from revenue as interest expense or interest income in the statement of comprehensive income. An entity would not be precluded from presenting interest income recognized from contracts with a significant financing component as revenue, if it generates interest income in the normal course of business similar to a financial services entity.

Retainage

Many construction contracts include a provision allowing one party to withhold a percentage of the contractual payment until a project is substantially complete. The amount withheld is commonly referred to as a retainage. Retainages are intended to address concerns a contractor will not finish a project if full payment already has been made. ASU 606 makes an exception for certain differences between the promised consideration and the cash selling price of the goods or services. A contract would not be considered to have a significant financial component if the difference stems from a reason other than financing to either the customer or contractor and the difference is proportional to the reason for the difference.

An entity paying in advance for goods or services would not reflect the time value of money if the transfer of goods or services to a customer is at the customer’s discretion. As a result, a prepayment to secure supplies would not be considered a significant financing component.

**Example**

An entity enters into a construction contract that includes scheduled milestone payments for performance by the entity throughout the three-year contract. The performance obligation will be satisfied over time, and the milestone payments are scheduled to coincide with the expected performance. A percentage of each milestone payment is to be retained by the customer and only paid upon the building’s completion. Since the milestone payments coincide with the entity’s performance and the retainage amounts are related to performance, the entity concludes the contract does not include a significant financing component. Retainages are intended to protect the customer from the contractor failing to complete its obligations under the contract.

TRG members discussed several issues related to the assessment of a significant financing component and generally agreed on the following:
Entities should not automatically assume there is no significant financing component if the promised consideration is equal to the cash price. This fact should be considered but is not determinative.

Advance payments are not excluded from review for significant financing. Judgment is required. An entity should adjust for financing if the timing of payments specified provide the customer or the entity with a significant financing benefit.

A financing component would be accreted as an interest expense for advanced payments or interest income for payment in arrears over the financing arrangement’s term.

Entities are not precluded from accounting for a financing component that is not significant. Entities with a portfolio of contracts that include both significant and insignificant financing components can account for the financing component consistently across all its contracts instead of having to apply two accounting methods.

Entities will need to use judgment in allocating a significant financing component when there are multiple performance obligations in a contract. It might be possible to determine that a significant financing component relates specifically to one (or some) of the performance obligations in the contract.

Entities may be required to recognize interest income or expenses, and total revenue could be more or less than the consideration received.

<table>
<thead>
<tr>
<th>Significant Financing Component</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current U.S. GAAP</strong></td>
</tr>
<tr>
<td>Interest is imputed for receivables arising from the normal course of business that are due in more than one year.</td>
</tr>
<tr>
<td>Interest is computed based on the stated rate in the contract or a market rate when discounting is required.</td>
</tr>
</tbody>
</table>

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For some transactions, the receipt of consideration does not match the timing of the transfer of goods or services to the customer. For such contracts, the Company evaluates whether this timing difference represents a financing arrangement within the contract. Although rare, if a contract is determined to contain a significant financing component, the Company adjusts the promised amount of consideration for the effects of the time value of money when determining the transaction price of such contract. Although our customers may retain a portion of the contract price until completion of the project and final contract settlement, these retainage amounts are not considered a significant financing component as the intent of the withheld amounts is to provide the customer with assurance that we will complete our obligations under the contract rather than to provide financing to the customer. In addition, although we may be entitled to advanced payments from our customers on certain contracts, these advanced payments generally do not represent a significant financing component as the payments are used to meet working capital demands that can be higher in the early stages of a contract, as well as to protect us from our customer failing to meet its obligations under the contract.
Noncash Consideration

If a customer promises consideration in a form other than cash, an entity would measure the noncash consideration at fair value (FV) to determine the transaction price. If a reasonable estimate of FV of the noncash consideration cannot be made, the estimated selling price of the promised goods or services would be used. This is similar to current accounting standards.

ASU 2014-09 did not specify a measurement date for noncash consideration. ASU 2016-12 clarifies noncash consideration would be measured at contract inception. Subsequent changes in FV of the noncash consideration due to the form of the consideration would be recorded, if required, as a gain or loss in accordance with other accounting guidance—rather than as revenue. For example, if the GAAP related to the form of noncash consideration require an asset to be measured at FV, then an entity will recognize a gain or loss (outside of revenue) upon receipt of the asset if the FV of the noncash consideration increased or decreased since contract inception.

Consideration Payable to a Customer

Consideration payable to a customer includes amounts that an entity pays—or expects to pay—to a customer in the form of cash or noncash items, which the customer can apply against amounts owed to the entity. An entity would evaluate the consideration to determine whether the amount represents a reduction of the transaction price, a payment for distinct goods or services or a combination of the two. An entity would reduce the transaction price by the amount it owes to the customer, unless the consideration owed is in exchange for distinct goods or services transferred from the customer to the entity.

If the consideration owed to the customer is payment for distinct goods or services from the customer to the entity, the entity would account for the purchase of these goods or services similarly to purchases from suppliers. If the amount of consideration owed to the customer exceeds the FV of those goods or services, the entity would reduce the transaction price by the amount of the excess. If the entity cannot estimate the FV of the goods or services it receives from the customer, it would reduce the transaction price by the total consideration owed to the customer.

An entity would recognize the reduction in revenue associated with adjusting the transaction price for consideration payable to a customer at the later of the following dates:

- When the entity recognizes revenue for the transfer of goods or services to the customer
- When the entity pays or promises to pay the consideration to the customer (this could be implied by customary business practices)

Step 4 – Allocate the Transaction Price to the Separate Performance Obligations

An entity would allocate the transaction price to performance obligations based on the relative standalone selling price of separate performance obligations. The best evidence of standalone selling price would be the observable price for which the entity sells goods or services separately. In the absence of separately observable sales, the standalone selling price would be estimated by maximizing the use of observable inputs and considering all information reasonably available to the entity. The objective would be to allocate the transaction price to each
performance obligation in an amount that represents the consideration the entity expects to receive for its goods or services. Several approaches might be used:

- Adjusted market assessment: An entity would evaluate the market and estimate the price customers would pay; competitors’ price information might be used and adjusted for an entity’s particular cost and margins.
- Cost plus margin: An entity would forecast its expected cost to provide goods or services and add an appropriate margin to the estimated selling price.
- Residual value: An entity would subtract the sum of observable standalone selling prices for other goods and services promised under the contract from the total transaction price to obtain an estimated selling price for a performance obligation. This approach would be appropriate only if the selling price is highly variable or uncertain, e.g., intellectual property where there is little or no incremental cost or a new product where price has not been set or the product has not been previously sold.

The use of the residual value approach is more limited within the ASU than under current accounting guidelines. The residual method becomes an estimation technique rather than an allocation methodology.

Where more than one good or service has a highly variable price or is uncertain, an entity could use a combination of techniques to estimate their standalone selling price. An entity would first apply the residual approach to estimate the aggregate price for all the goods and services with highly variable or uncertain standalone prices and use another technique to allocate the aggregated estimated selling prices to the remaining goods or services.

Example

A group of doctors approached a contractor about building a medical office and installing a nurse calling system. The office and call system are separate performance obligations and have a combined contract consideration of $20 million. The relative standalone selling price of the office is $25 million and the call center $1 million (see below).

<table>
<thead>
<tr>
<th>Product</th>
<th>Price Method</th>
<th>Standalone Selling Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Office</td>
<td>Relative value</td>
<td>25</td>
</tr>
<tr>
<td>Calling System</td>
<td>Relative value</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>26</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Product</th>
<th>Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Office</td>
<td>25/26 x 20</td>
</tr>
<tr>
<td>Calling System</td>
<td>1/26 x 20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
</tr>
</tbody>
</table>

Changes in Transaction Price & Variable Consideration

If the transaction price changes after contract inception, an entity would allocate the change to separate performance obligations in the same manner it allocates the transaction price at contract inception. Any change in the transaction price allocated to a satisfied performance obligation would be recognized as revenue or a reduction in revenue in the period the change occurs. An entity would allocate a change in transaction price to a
single distinct good or service or group of goods or services using the same criteria applied to variable consideration noted below.

Variable consideration may be attributable to the entire contract or a specific part of a contract. Variable consideration—and any subsequent changes—would be entirely allocated to a distinct good or service only if the variable payment specifically relates to either of the following:

- The entity's efforts to transfer that distinct good or service
- A specific outcome of transferring that distinct good or service

Allocating the variable consideration entirely to the performance obligation or the distinct good or service is consistent with the general allocation principle that the transaction price should be allocated to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation, considering all of the performance obligations and payment terms in the contract.

### Allocating the Transaction Price

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Except for allocation guidance related to contract segmentation, there is no explicit guidance on allocating contract revenue to multiple deliverables in a construction contract.</td>
<td>An entity would allocate the transaction price to all separate performance obligations based on the relative standalone selling price of separate performance obligations.</td>
</tr>
</tbody>
</table>

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> For contracts that contain multiple performance obligations, the Company allocates the transaction price to each performance obligation based on a relative standalone selling price. The Company determines the standalone selling price based on the price at which the performance obligation would have been sold separately in similar circumstances to similar customers. If the standalone selling price is not observable, the Company estimates the standalone selling price taking into account all available information such as market conditions and internal pricing guidelines. In certain circumstances, the standalone selling price is determined using an expected profit margin on anticipated costs related to the performance obligation.

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**Step 5 – Recognize Revenue When (or as) Performance Obligations Are Satisfied**

An entity would recognize revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when the customer obtains control of the asset. For some industries, such as real estate, this is a significant departure from the current risk and rewards criteria.
Change in control would occur when the customer has the ability to direct the use of and receive the benefits from the transferred good or service. Control also includes the customer’s ability to prevent other entities from directing the use of and obtaining the benefit from the good or service. Revenue can be recognized over time or at a point in time.

For construction companies, assessing whether a transaction meets the criteria to recognize revenue over time will be a key accounting judgment. This assessment is made at the performance obligation level rather than the contract level.

Performance Obligations Satisfied Over Time

An entity transfers control over time if any of the following criteria are met:

- The customer receives and consumes the benefits of the entity’s performance as the entity performs, e.g., a cleaning service.
- The customer controls the asset as it is created or enhanced by the entity’s performance—this could be tangible or intangible.
- The entity’s performance does not create an asset with an alternative use to the entity and the customer does not have control over the asset created, but the entity has an enforceable right to payment for performance completed to date and expects to fulfill the contract as promised.

To determine if an asset has an alternative use, the entity considers at contract inception the effects of contractual and practical limitations on its ability to readily direct the asset to another customer. An asset would not have an alternative use if an entity is prohibited from transferring the asset to another customer or would incur significant costs to redirect.

An entity has an enforceable right to payment for performance to date if an entity is allowed to recover cost plus margin on goods and services transferred to date. The right to payment should be enforceable, and management should consider the contractual terms as well as any legislation or legal precedent that could override those contractual terms. The right to payment for performance completed to date need not be for a fixed amount.

Determination of transfer of control is straightforward for manufactured goods. For construction services, it can be difficult to assess whether a customer has the ability to direct the use of and obtain all the remaining benefits from a partially completed asset. For a contractor building on a customer’s land, the customer generally controls any work in progress arising from the contractor’s performance.
There are several methods for recognizing revenue depending on the contract’s details:

- **Construction**
  - Percentage of completion method
  - Completed contract method

An entity transfers control over time if any of these criteria are met:

- The customer controls the asset as it is created or enhanced.
- The customer receives and consumes the benefits as the entity performs.
- The asset has no alternative use and the customer does not control the asset created; the entity has a right to payment for performance to date and the entity expects to fulfill the contract as promised.

**Measuring Progress Toward Complete Satisfaction of Performance Obligation**

An entity would recognize revenue for a performance obligation satisfied over time only if it can reasonably measure its progress toward completion. In some cases, e.g., a contract’s early stages, an entity would be permitted to recognize revenue to the extent costs are incurred until the entity can reasonably measure its progress toward completion. An entity can measure its progress toward completion using either output or input methods—it would be required to apply that method consistently to similar performance obligations in similar circumstances.

*Within each performance obligation, the contractor may continue reporting revenue in a manner consistent with the current percentage of completion method.*

**Output Methods**

Under an output method, an entity would recognize revenue by directly measuring the value of the goods and services transferred to date to the customer (milestones reached or units produced). The output selected should faithfully depict the entity’s progress toward satisfaction of a performance obligation. For example, units produced or delivered only could be used if the value of any work in progress and units produced but not delivered to the customer at the end of the reporting period is immaterial. As a practical expedient, an entity could recognize revenue in the amount it is entitled to invoice if it directly corresponds with the value of the goods or services transferred to date.

*It is common practice in the construction industry to periodically bill an owner of a project for progress completed and materials delivered to the job site. An entity would recognize revenue in the amount it is entitled to invoice if it directly corresponds with the value of the goods or services transferred to date. An entity may not be entitled to payment for work performed until specified performance milestones are met. If an entity receives payment for work performed only when achieving certain milestones, the continuous transfer method still may be appropriate for recognizing revenue of work performed before reaching a specific milestone (prior to achieving a present right to payment).*

**Input Methods**

Input measures use an entity’s inputs, e.g., costs incurred, machine hours used or time lapsed, relative to the total expected inputs to satisfy a performance obligation. If inputs are incurred evenly over time, revenue would be
recognized on a straight-line basis. An entity must adjust if the inclusion of certain costs would distort the contract’s performance, e.g., wasted materials, labor or other resources needed to fulfill the contract that were not reflected in the contract price. ASC 606 focuses on recognition of revenue rather than margin.

**Measuring Progress**

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Input methods, output methods or passage of time can be used to measure progress toward completion.</td>
<td>Input methods or output methods can be used to measure progress toward completion.</td>
</tr>
<tr>
<td>Gross profit method of calculating revenue, costs and gross profits based on the percentage complete is permitted.</td>
<td>Gross profit method of calculating revenue, costs and gross profits based on the percentage complete is no longer allowed.</td>
</tr>
</tbody>
</table>

For entities using the percentage complete on the cost-to-cost method, removal of cost that would distort the contract’s performance, such as wasted materials, from the percentage of completion calculation will defer recognition of revenue on projects and reduce profits on early stages of projects.

**Example**

An entity enters into a contract with a customer to build a single family home for $3 million. A portion of the drywall purchased was defective (no scrap value), and a different product had to be ordered. Including the cost of the defective drywall in the percentage completion calculation distorts the contract’s performance.

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New Model (excluding wasted materials cost)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost to date</td>
<td>400,000</td>
</tr>
<tr>
<td>Less wasted materials</td>
<td>(200,000) (wasted drywall – expensed)</td>
</tr>
<tr>
<td>Subtotal</td>
<td>400,000</td>
</tr>
<tr>
<td>Total estimated project costs</td>
<td>2,400,000</td>
</tr>
<tr>
<td>Percent complete</td>
<td>17%</td>
</tr>
<tr>
<td>Total contract amount</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Revenue to be recognized</td>
<td>510,000</td>
</tr>
<tr>
<td>Job costs capitalized</td>
<td>(400,000)</td>
</tr>
<tr>
<td>Costs directly expensed</td>
<td>0</td>
</tr>
<tr>
<td>Gross profit (loss) to be recognized</td>
<td>110,000</td>
</tr>
</tbody>
</table>

**Uninstalled Materials**

If an entity acting as a principal procures goods from another vendor and does not design or manufacture those goods, and the cost of the goods is significant relative to the total cost to satisfy the performance obligation and
control of the goods is transferred to the customer significantly in advance of delivery or services related to those goods, an entity may recognize revenue in an amount equal to the cost of the goods, i.e., zero-margin revenue on those specific goods.

The standard provides four criteria that—if all are met—may indicate a cost incurred is not proportionate to the entity’s progress in satisfying the performance obligation and, therefore, the best depiction of the entity’s performance may be to adjust the input method to recognize revenue only to the extent of that cost incurred. These criteria are as follows:

- The good is not distinct. In most cases, the procurement of materials necessary to complete a performance obligation would not typically be considered a separate performance obligation. When the contractor can readily use materials in other construction projects without incurring significant costs to modify the items, the Task Force believes such inventoriable materials should be considered for inclusion as an uninstalled material if control has transferred to the customer if the three other criteria are met.

- The customer is expected to obtain control of the good significantly before receiving services related to the good.

- The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.

- The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good (but the entity is acting as a principal). The Task Force concluded if the contractor is significantly involved in the design and manufacturing of an item—even if the item is procured from a third-party manufacturer—then the procurement of such specifically designed materials would represent progress toward satisfying a performance obligation. This often is the case when an integrated engineering and construction company designs materials that are fabricated for a specific project by a third party, such as a nuclear power plant’s prefabricated concrete walls.

If it is determined that uninstalled materials meet all the above criteria, the contractor should recognize revenue for the transfer of the goods but only in an amount equal to the cost of those goods. In those circumstances, the contractor also should exclude the costs of the goods from the cost-to-cost calculation to be consistent with the cost-to-cost methodology.

The Task Force believes a careful evaluation of the facts and circumstances is required to determine whether the exclusion from the input method of goods that meet these criteria would be a better depiction of the measure of progress toward completion of a performance obligation. This evaluation should be performed at inception and throughout the contract’s duration.

Uninstalled materials attract a zero margin only as a way to adjust the cost-to-cost calculation for the input material to faithfully depict the entity’s performance in the contract.
**Example: Uninstalled Materials**

An entity enters into a contract with a customer to construct a facility for $140 million over two years. The contract also requires the entity to procure specialized equipment from a third party and integrate that equipment into the facility. The entity expects to transfer control of the specialized equipment six months from when the project begins. The installation and integration continue throughout the contract. The contract is a single performance obligation because all the promised goods or services are highly interrelated and the entity also provides a significant service of integrating these goods and services into a single facility. The entity measures progress on the basis of costs incurred relative to total costs expected to be incurred.

<table>
<thead>
<tr>
<th>Transaction price</th>
<th>$140 million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of the specialized equipment</td>
<td>$40 million</td>
</tr>
<tr>
<td>Other costs</td>
<td>$80 million</td>
</tr>
<tr>
<td>Total expected cost</td>
<td>$120 million</td>
</tr>
</tbody>
</table>

The entity concludes the best depiction of its performance is to recognize revenue for the specialized equipment upon transfer to the customer. The entity would exclude that cost from its measure of progress on a cost-to-cost basis.

During the first six months, the entity incurs $20 million of costs (excluding the equipment). It estimates the performance obligation is 25 percent complete ($20 million of $80 million) and recognizes revenue of $25 million (25% x ($140 million total transaction price - $40 million equipment)).

Upon transfer of the equipment, the entity recognizes revenue and costs of $40 million.

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For our construction contracts, revenue is generally recognized over time as our performance creates or enhances an asset that the customer controls. Our fixed price construction projects generally use a cost-to-cost input method to measure our progress towards complete satisfaction of the performance obligation as we believe it best depicts the transfer of control to the customer. Under the cost-to-cost measure of progress, the extent of progress towards completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. For our unit price construction contracts, progress towards complete satisfaction is measured through an output method such as the amount of units produced or delivered, when our performance does not produce significant amounts of work in process or finished goods prior to complete satisfaction of such performance obligations.

For our services contracts, revenue is also generally recognized over time as the customer simultaneously receives and consumes the benefits of our performance as we perform the service. For our fixed price service contracts with specified service periods, revenue is generally recognized on a straight-line basis over such service period when our inputs are expended evenly, and the customer receives and consumes the benefits of our performance throughout the contract term.

The timing of revenue recognition for the manufacturing of new build heat exchangers within our United States industrial services segment depends on the payment terms of the contract, as our performance does not create an asset with an alternative use to us. For those contracts which we have a right to payment for performance completed to date at all times throughout our performance, inclusive of a cancellation, we recognize revenue over time. These performance obligations use a cost-to-cost input method to measure our progress towards complete satisfaction of the performance obligation as we believe it best depicts the transfer of control to the customer. However, for those contracts for which we do not have a right, at all times, to payment for
Revenue Recognition: Construction Industry Supplement

**Control Transferred at Point in Time**

Performance obligations not meeting any of the three criteria for being satisfied over time should be accounted for at a point in time. When control over an asset is transferred at a single point in time, an entity would recognize revenue by evaluating when the customer obtains control. An entity would use judgment to determine when control has been transferred, considering the following indicators:

- The entity has a present right to payment.
- The customer has legal title.
- The customer has physical possession.
- The customer has the significant risks and rewards of ownership.
- The customer has accepted the asset.

Clauses allowing a customer to cancel a contract or requiring an entity to take remedial action if a good or service does not meet agreed-upon specifications must be evaluated to determine if a customer has obtained control.

*If the developer of a multiunit housing complex enters into a contract to sell a specific apartment to a specific customer, that apartment does not have an alternative use to the developer because the entity cannot use that apartment to fulfill a contract with another customer without breaching its contract to the first customer. However, if the contract did not also require the customer to pay for performance completed to date, the developer would be able to recognize revenue only at the point when the specific apartment was transferred to the customer.*

---

### Revenue Recognized at a Point in Time

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue is not recognized until the seller has substantially accomplished what it must do under the contract’s terms. Risk and rewards of ownership must pass upon delivery for revenue to be recognized. Specialized industry accounting determines the appropriate accounting. The rights and obligations of the parties, pattern of cash flows and nature of interest retained by the seller must be evaluated.</td>
<td>An entity would recognize revenue when (or as) control is transferred to a customer.</td>
</tr>
</tbody>
</table>
Other Items

Contract Costs

Existing construction contract guidance contains a substantial amount of cost capitalization guidance, both related to pre-contract costs and costs to fulfill a contract. In conjunction with the release of the new standard, FASB amended ASC 340, Other Assets and Deferred Costs. Under the ASU, entities likely would capitalize more contract costs than under existing U.S. GAAP. An entity that currently elects to expense eligible contract costs might now be required to capitalize those costs. For example, sales commissions that are expensed as paid would be capitalized if the costs are recoverable.

There have been no changes to guidance on the capitalization of interest costs.

| All costs incurred prior to when the customer obtains control will need to be reviewed to determine if an asset should be recognized. Pre-contract costs can include fulfillment costs on anticipated contracts or costs to obtain a contract. Management’s decision process on the transition strategy should contemplate any costs incurred for contracts that are not completed upon adoption of ASC 606. |

Incremental Costs of Obtaining a Contract

An entity would capitalize the incremental costs of obtaining a contract if the costs are recoverable. Incremental costs are those that would not have been incurred if the contract had not been obtained, e.g., sales commissions. Costs an entity incurs regardless of whether it obtains a contract would be expensed as incurred. As a practical expedient, an entity can expense these incremental costs if the amortization period of those costs would be one year or less, i.e., contract term or earnings process is not greater than a year. An entity must disclose if this practical expedient is elected.

| An entity is precluded from deferring costs merely to normalize profit margins throughout a contract by allocating revenue and costs evenly over the life of the contract. |

Costs to Fulfill a Contract

If the costs incurred in fulfilling a contract are not within the scope of other guidance, e.g., inventory, property, plant and equipment or capitalized software, an entity would recognize an asset only if the costs meet all of the following criteria:

- Directly relate to a contract or a specific anticipated contract, such as direct labor or materials
- Generate or enhance resources that would be used to satisfy performance obligations in the future
- Are expected to be recovered

For engineering and construction contracts, costs that directly relate to a contract could include direct labor, direct materials and allocations of costs that are explicitly chargeable to the customer under the contract and other costs that were incurred only because the entity entered into the contract, e.g., subcontractor arrangements. General and administrative costs are expensed as incurred if they are not explicitly chargeable to the customer under the contract. If an entity cannot distinguish the fulfillment costs related to future performance obligations from the costs related to past performance obligations, the entity would expense these costs as incurred.

| The definition of “incremental costs of obtaining a contract” implies only external costs generally could be recognized as an asset. Internal costs are less likely to meet the “incremental” test, e.g., an allocation of bid team staff cost may be unlikely to meet the criteria to be recognized as an asset. Judgment will be needed to determine whether construction design costs and bidding expenses incurred as part of contract negotiations represent a cost of fulfilling the contract or obtaining a contract. |
Wasted materials, labor or other resources to fulfill a contract that were not reflected in the contract’s price should be expensed when incurred. Higher quantities or costs compared to the original budget do not necessarily equate to wasted materials, labor or other resources. Determining which costs are “wasted” will require significant judgment and vary depending on the facts and circumstances.

If incorrect materials are used by mistake and need to be replaced due to a construction error, the “wasted” materials would result in immediate expense, presuming the materials could not be used elsewhere. However, in another situation, an engineer may be more efficient as more drawings are produced. This does not necessarily result in the earlier engineering drawings incurring “wasted” labor. Rather, efficiency gains simply reduce costs going forward.

Learning or Startup Costs

A learning curve is the effect of efficiencies realized over time when an entity’s costs of performing a task (or producing a unit) declines in relation to how many times the entity performs that task (or produces that unit). Such costs usually consist of materials, labor, overhead, rework or other special costs that must be incurred to complete the existing contract or contracts in progress and are distinguished from research and development costs. As a cost activity matures over its life cycle, the expectation is that these costs would decline over time. These costs are often anticipated and contemplated between the contractor and customer and considered in negotiating and establishing the aggregate contract price. If an entity has a single performance obligation to deliver a specified number of units and the performance obligation is satisfied over time, an entity may select a method under FASB ASC 606 (such as cost-to-cost) that results in the entity recognizing more revenue and expense for the early units produced relative to the later units.

For example, assume a contractor is engaged to construct a 10-story building. The contractor determined there is a single performance obligation that is satisfied over time and that revenue will be recognized using an input measure, e.g., a cost-to-cost input method. The bottom floors of the building are expected to cost more than the top floors due to the learning curve costs involved. Therefore, the contractor will recognize more revenue and contract costs for the first components produced as compared to the later components.

Startup or learning costs incurred for anticipated but unidentified contracts would most likely not be capitalized before a specific contract was identified. Contractors may incur mobilization costs to move personnel, equipment and supplies to the project site. Contractors also may incur on-site, pre-construction cost in the form of temporary facilities for a construction project, e.g., offices, construction parking areas, access roads and utilities. These pre-construction costs often establish facilities on the customer’s property, and the related requirements for these facilities are specified in the contractual arrangements with the customer.

Once the contractor commences performance for a performance obligation satisfied over time, contract costs incurred to satisfy the performance obligation generally will not be eligible for capitalization and should be expensed when incurred in accordance with paragraphs 8c or 8d of FASB ASC 340-40-25. Contractors should analyze mobilization and pre-construction activities to determine whether they are incurred while satisfying a performance obligation(s) to a customer. For example, when mobilization or pre-construction fulfillment activities are a necessary part of satisfying a performance obligation(s) and control is continuously transferred to the customer, the Task Force believes the related costs should be recognized as costs of goods sold as incurred. Otherwise, these costs should be capitalized as fulfillment costs if the criteria in ASC 340 are met.

Pre-Contract Costs

Costs may be incurred in anticipation of a specific contract—or anticipated follow-on order—that will result in no future benefit unless the contract is obtained. Examples include:

- Engineering, design, mobilization or other services performed on the basis of commitments or other such indications of interest
- Costs for production equipment and materials relating to specific anticipated contracts, e.g., costs for the purchase of equipment, materials or supplies
Costs incurred to acquire or produce goods in excess of contractual requirements in anticipation of follow-on orders for the same item

Startup or mobilization costs incurred for anticipated but unidentified contracts

An entity would first evaluate if these costs should be capitalized under other authoritative literature, such as ASC 330, Inventory, or ASC 360, Property, Plant and Equipment. Pre-contract costs incurred for a specific anticipated contract that are not addressed under other authoritative literature would be recognized as an asset only if they meet all of the above costs to fulfill a contract criteria.

Amortization & Impairment

Capitalized costs to obtain and fulfill contracts would be amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. An entity should update the amortization period to reflect significant changes in the expected timing of transferring goods or services to the customer; these changes should be accounted for as changes in accounting estimates. As a practical expedient, if the amortization period would be one year or less, an entity may elect to expense the costs. The asset may be amortized over more than one contract when the asset relates to goods or services to be provided under an anticipated contract that the entity can identify specifically, e.g., renewal options.

An impairment loss would be recognized if the carrying value of the capitalized costs exceeds its recoverable amount. The recoverable amount equals the remaining consideration to which the entity expects to be entitled, minus costs directly related to those goods or services. Reversals of these impairments would not be permitted.

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract costs generally include all direct costs and indirect costs identifiable with or allocable to the contracts.</td>
<td></td>
</tr>
<tr>
<td>Costs shall be considered period costs if they cannot be clearly related to production, either directly or by an allocation based on discernible future benefits.</td>
<td></td>
</tr>
<tr>
<td>General and administrative costs may be accounted for as contract costs under the completed contract method of accounting.</td>
<td></td>
</tr>
<tr>
<td>The incremental cost of obtaining a contract would be capitalized if recoverable.</td>
<td></td>
</tr>
<tr>
<td>Fulfillment costs would be capitalized only if they meet all of the following criteria:</td>
<td></td>
</tr>
<tr>
<td>▪ Directly relate to an existing contract or specific anticipated contract, e.g., direct labor or materials</td>
<td></td>
</tr>
<tr>
<td>▪ Generate or enhance resources that would be used to satisfy performance obligations in the future</td>
<td></td>
</tr>
<tr>
<td>▪ Expected to be recovered</td>
<td></td>
</tr>
<tr>
<td>Costs that do not meet the criteria for capitalization shall be expensed as incurred.</td>
<td></td>
</tr>
</tbody>
</table>

Onerous Performance Obligations

An early exposure draft proposed changes to the onerous contracts guidance, but based on industry feedback, FASB decided to retain existing guidance. Entities would continue to use existing guidance in ASC 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, to account for losses arising from contracts with customers.
Principal Versus Agent Considerations

If other parties are involved in providing goods or services to an entity’s customer, the entity would determine whether it is acting as a principal or an agent. Distinguishing between principal versus agency roles requires significant judgment and is a challenge even under current guidance due to growth in the service industry and rise in “virtual” transactions. This distinction is important because it determines if revenue is recognized on a gross or net basis.

If an entity obtains control of goods or services from another party before transfer to the customer, the entity’s performance obligation is to provide the goods or services, meaning the entity is acting as a principal and would recognize revenue at the gross amount collected from the customer. If an entity obtains legal title of a good only momentarily before being transferred to a customer, the entity may not be acting as a principal. If an entity does not obtain control of the goods or services from another party before transfer to a customer, the entity is acting as an agent and would recognize revenue at the net amount, such as a fee or commission.

SEC Observations

The determination of whether a company is the principal or agent could be challenging for evolving business models and could be different from the conclusion reached under current U.S. GAAP. In adopting ASC 606, companies should revisit their current principal versus agent conclusions based on whether they control the specified good or service before it is transferred to the customer.

Gross or net reporting should not be viewed as a default or safe harbor. Instead, the specific facts and circumstances of an arrangement should drive the final accounting conclusion. Disclosures related to the principal versus agent determination are important because they allow investors to understand the registrant’s role in the arrangement.

Unit of Account

ASU 2016-08 requires an entity to identify the specified good or service provided to the customer, e.g., good, service or a right to a good or service. An entity then determines whether it is a principal or an agent for each promised good or service. If a customer contract includes more than one good or service, an entity could be a principal for some items and an agent for others.

Control in Service Contract

ASU 2016-08 clarifies how the control principle applies to services performed by another party. A principal can control a service—even when another party actually performs the service—if it can direct that party to perform the service for the customer on its behalf, e.g., an entity that provides office maintenance services but subcontracts with another party to perform the services instead of using its own employees. In contracts where goods or services provided by another party are inputs to a combined item, an entity would be the principal if it controls the combined item before transfer to the customer, e.g., integration services.

Indicators

ASU 2016-08 clarifies the indicators in ASC 606 may be more or less relevant or persuasive to the control assessment, depending on the facts and circumstances. This ASU also eliminates the indicators related to credit risk and consideration in the form of commission. The control indicators in the original 2014 standard were drafted from an agent’s point of view (when an entity did not control the goods/services before transfer). This ASU reframes the indicators from the principal’s point of view (when an entity controls the goods/services before transfer), which is more intuitive for readers.
Transfers of Assets that Are Not an Output of an Entity’s Ordinary Activities

The requirements on the existence of a contract, control and measurement—including the revenue constraint—would apply to the sale or transfer of nonfinancial assets, e.g., disposal of capital assets. These requirements would determine when to derecognize an asset and the amount of gain or loss on the sale. No guidance exists in U.S. GAAP to account for the transfer of nonfinancial assets other than real estate. FASB agreed on consequential amendments—affecting ASC Subtopic 360-20, Subtopic 360-10 and Topic 350—so accounting for the sale of real estate is the same regardless of whether real estate is an output of the entity’s ordinary activities. The only difference would be in presentation—revenue and expense or gain or loss.

Presentation

An entity would present a contract in its statement of financial position as a contract liability, contract asset or receivable, depending on the relationship between the entity’s performance and the customer’s performance at the reporting date. A contract liability exists if the customer has paid consideration or if payment is due as of the reporting date but the entity has not yet satisfied the performance obligation. If an entity has transferred goods or services as of the reporting date but the customer has not yet paid, the entity would recognize either a contract asset or receivable. An unconditional right to consideration is presented as a receivable. If an entity’s right to consideration is conditioned on something other than the passage of time, an entity would recognize a contract asset. FASB felt the distinction between a contract asset and receivable provided financial statement users with relevant information about an entity’s risk exposure. While both asset categories are subject to credit risk, a contract asset also is subject to other issues such as performance risk.

Under ASC 606, if a contractor delivers services to a customer before the customer pays consideration, the contractor should record either a contract asset or receivable depending on the nature of the contractor’s rights to consideration for its performance. The transfer from a contract asset to an account receivable balance—when the contractor has a right to payment—may not coincide with the timing of the invoice as is required under the current guidance. The cost in excess of billing and billings in excess of cost initially recognized on the balance sheet under current GAAP should be similar to the contract asset and contract liability recognized under the new standard.

<table>
<thead>
<tr>
<th></th>
<th>Current Terminology</th>
<th>ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset</strong></td>
<td>Unbilled receivables -revenue has been recognized as the performance of the contract work is being performed, but the amount cannot be billed under the contract’s terms until a later date. These are also referred to as “Costs and Estimated Earnings in Excess of Billings on Uncompleted Contracts” or “Underbillings”</td>
<td>An entity would present a contract in its statement of financial position as a contract liability, contract asset or receivable, depending on the relationship between the entity’s performance and the customer’s performance at the reporting date.</td>
</tr>
<tr>
<td><strong>Liability</strong></td>
<td>Billings in excess of cost and estimated earnings on uncompleted contracts - Represents an obligation for work to be performed (billings in excess of revenues earned), also referred to as “Overbillings”</td>
<td></td>
</tr>
</tbody>
</table>
Entities are permitted to use different descriptions of contract assets, contract liabilities and receivables and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for financial statement users to distinguish them.

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As a result of the adoption of this standard, certain changes have been made to the Condensed Consolidated Balance Sheets. The accounts previously named “Costs and estimated earnings in excess of billings on uncompleted contracts” and “Billings in excess of costs and estimated earnings on uncompleted contracts” have been renamed “Contract assets” and “Contract liabilities”, respectively. In addition, for periods beginning after December 31, 2017, amounts representing deferred revenues on services contracts, which were previously included in “Other accrued expenses and liabilities” within the Condensed Consolidated Balance Sheets, have been reclassified as “Contract liabilities.”

**Disclosures**

The objective of the disclosure requirements is to enable financial statement users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. BKD has prepared a separate white paper on the new required disclosures that is applicable for all industries, “Revenue Recognition: New Disclosures.” FASB provided significant relief to entities that do not meet the definition of a public entity (see Appendix B for a summary of requirements for public and nonpublic entities).

Companies that have early adopted the standard have found this area to be more challenging than initially anticipated. For companies with a large number of contracts, the preparation of these disclosures may be an onerous task. Construction companies should ensure they have systems, internal controls and procedures in place to accumulate the information required to satisfy these new presentation and disclosure requirements.
Disaggregation

When determining how to disaggregate revenue for disclosure purposes, an entity should consider how investors, regulators and lenders use the information to evaluate the entity’s financial performance. **Public entities** must disaggregate revenue in meaningful categories. For construction companies, common categories of disaggregated revenue include residential and commercial contracts, revenue from public sources (governments, etc.) and private sources, geographic region and contract duration. If a company reports segment information in its financial statements, it must disclose sufficient information to enable users of financial statements to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment.

The ASU provides relief to nonpublic entities on this requirement. At a minimum, revenue must be disaggregated according to the timing of transfer of goods or services—point-in-time versus over-time revenue recognition—and should include qualitative information about how economic factors affect the nature, timing and uncertainty of revenue and cash flows. Engineering and construction entities that are not public business entities and primarily focus on a single market may not find it necessary to further disaggregate revenue to achieve the disclosure objectives.

Disaggregation of revenue does not mean disclosing individual contract information that is often requested by sureties.

Contract Balances

Entities must report contract assets separately from patient accounts receivable on the balance sheet. A contract asset is an unbilled amount for services, while a receivable is a billed but not collected payment for services rendered. A contract liability is generated when a customer prepays before a contractor completes all its obligations. A contract liability does not include amounts expected to be refunded. Companies also will need to disclose whether there is a financing component included in its payment arrangements and how it is estimated.

Under ASC 606, reclassification from a contract asset to a receivable is contingent on fulfilling performance obligations—not on invoicing a client. As a result, the point at which a contract asset is reclassified as a receivable may be different than the time of invoicing.
All entities must present opening and closing balances of receivables, contract assets and liabilities on the balance sheet or in the notes to the financial statements. FASB again provides significant relief for nonpublic entities. Only public entities are required to explain significant changes in the contract asset and liability balances during the reporting period. Public entities will need to disclose reductions in a contract liability balance for services provided during the reporting period. The explanation must include both qualitative and quantitative information. Public entities must disclose how the timing of satisfaction of their performance obligations relates to the typical timing of payment and the effect those factors have on the contract asset and liability balances. An entity can use qualitative information.

*Entities can use different descriptions of contract assets, contract liabilities and receivables and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for financial statement users to distinguish them.*

**Performance Obligations**

All entities must disclose how performance obligations are satisfied, i.e., at a point in time or over time, significant payment terms, if the consideration is variable and if the estimate of variable consideration is constrained. All entities must describe the nature of goods or services provided and highlight if an entity is acting as an agent.

**Transaction Price Allocated to the Remaining Performance Obligations**

For construction companies with remaining performance obligations at the end of the reporting period, the following disclosures are required for public entities:

- The aggregate amount of the transaction price allocated to the unsatisfied performance obligations at the end of the reporting period
- An explanation of when the entity expects to recognize such revenue in either of the following ways:
  - Quantitatively using time bands based on the duration of the remaining performance obligations
  - Qualitatively

FASB provided two practical expedients from the above requirement:

- Disclosure is not required for remaining performance obligations if either of the following conditions is met:
  - The contract has an original expected duration of one year or less.
  - The entity recognizes revenue in an amount that directly corresponds with the value of the performance completed to date, e.g., an entity bills a fixed amount for each hour of service provided.
- Disclosure is not required for variable consideration within unsatisfied performance obligations if either condition is met:
  - The variable consideration is a sales- or usage-based royalty promised in exchange for a license of intellectual property.
  - The variable consideration is fully allocated to a wholly unsatisfied performance obligation or wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation under the series provision.

If an entity elects either of these practical expedients, it must disclose which exemptions it is applying, the nature of the performance obligations, remaining duration and a description of the excluded variable consideration. An entity shall explain whether any consideration is not included in the transaction price and, therefore, not included in the information disclosed, e.g., an estimate of the transaction price would not include any estimated amounts of constrained variable consideration.
Significant Judgments

All entities are required to disclose judgments and changes in judgments that significantly affect the amount and timing of revenue from customer contracts. This includes the timing of satisfaction of performance obligations and the transaction price and amounts allocated to performance obligations. All entities also must disclose the methods, inputs and assumptions made in assessing whether an estimate of variable consideration is constrained. Only public entities additionally must disclose the methods, inputs and assumptions for determining the transaction price, including estimating variable consideration, adjusting for significant financing, measuring noncash consideration and allocating the transaction price to goods and services.

For performance obligations satisfied over time, all entities should disclose the methods used to recognize revenue. For public entities only, there should be an explanation of why the methods used provide an accurate depiction of the transfer of goods or services.

For performance obligations satisfied at a point in time, public entities should disclose the significant judgments made in evaluating when a customer obtains control of the promised goods or services.

Capitalized Contract Costs

If a public entity capitalized costs to obtain or fulfill a contract, it will be required to make the following disclosures:

- Description of the judgments made in determining the amount of costs incurred to obtain or fulfill a contract
- Description of the method to determine the amortization for each reporting period
- The closing balances of assets recognized from the costs incurred by main category of asset, e.g., costs to obtain contracts, pre-contract costs and setup costs
- The amount of amortization and any impairment losses recognized in the reporting period

Transition

Entities must retrospectively apply the new revenue standard using either a full or modified retrospective approach. Each approach has relative benefits, costs and complexities. There is no “one size fits all” solution—it will depend on each entity’s specific facts and circumstances and which factors are most relevant. Some entities may consider comparability to peers or between reporting periods to be most relevant, while others may prioritize the cost of implementation. In other cases, an entity may consider comparability most important but determine the retrospective method is not feasible because it cannot make the necessary system changes in the required time frame at a reasonable cost.
Full Retrospective
Under this approach, entities would apply the new guidance as if it had been in effect since the inception of all customer contracts. FASB provided several practical expedients:

- For completed contracts, an entity need not restate contracts that begin and end within the same annual reporting period.
- For completed contracts that have variable consideration, an entity may use the transaction price at the date the contract was completed rather than estimating variable consideration amounts in the comparative reporting periods.
- For all reporting periods presented before the date of initial application, an entity need not disclose the amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognize that amount as revenue.
- ASU 2016-12 added an additional expedient for contract modifications, eliminating the need to separately evaluate the effects of each contract modification when determining the transaction price upon initial adoption of the standard. An entity could elect to perform a single standalone selling price allocation (with the benefit of hindsight) to all of the contract’s satisfied and unsatisfied performance obligations.

Entities can elect any or all of these expedients and would disclose that fact and a qualitative assessment of the estimated effects. Entities must apply each expedient selected consistently to all contracts for all periods presented.

Modified Retrospective
Under this approach, the cumulative effect of initially applying this ASU is recognized in opening retained earnings on adoption date. ASU 2016-12 permits an entity to elect to apply the modified retrospective transition approach either to all contracts as of the adoption date or only to uncompleted contracts. Entities are required to disclose how they applied the modified retrospective method.

Comparative-year restatement is not required, but entities must disclose the following additional information in reporting periods that include the initial adoption date:

- For each financial statement line item, the amount affected in the current reporting period by the application of this ASU as compared to the guidance that was in effect before the change
- An explanation of the reasons for significant changes
Entities electing a modified retrospective approach only can use the practical expedient related to contract modifications.

As originally issued, the standard would have required an entity electing modified retrospective application to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line items and any affected per-share amounts for the current period and any prior periods retrospectively adjusted, substantially increasing transition costs. For companies applying the guidance using the modified retrospective application, ASU 2016-12 eliminates the requirement to disclose the effect of the accounting change for period of adoption. However, entities still would need to disclose the changes’ effect on any prior periods retrospectively adjusted.

Completed Contracts

ASU 2016-12 clarifies that for a contract to be considered completed at transition, all—or substantially all—of the revenue must have been recognized under legacy GAAP before the date of initial application. Accounting for contract elements that do not affect revenue under legacy GAAP would be irrelevant to the assessment of whether a contract is complete.

A construction company that elects to apply the modified retrospective transition method only to contracts that are not completed as of the date of initial application should evaluate its contracts to determine if all or substantially all of the revenue was recognized under legacy GAAP, i.e., they are completed contracts, before the date of initial application.

Many contractors enter into agreements that can span multiple years; therefore, it is important to understand the effective dates in the new standard. Management will need to carefully consider the costs and benefits of these two approaches, which will affect the start date and data requirements of implementation projects.

The adoption of this ASU will be complex and likely will require significant hours to correctly implement. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance complying with the new revenue recognition standard, contact your trusted BKD advisor. BKD has prepared a library of BKD Thoughtware on revenue recognition issues. Visit our Hot Topics page to learn more.

Contributor

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Director
317.383.4000
acoughlan@bkd.com
### Appendix A – Internal Controls

<table>
<thead>
<tr>
<th>Five-Step Model</th>
<th>Considerations for New or Amended Controls</th>
</tr>
</thead>
</table>
| **Step 1: Identify the Contract with the Customer** | • Identifying arrangements (whether written or unwritten) that meet the contract criteria  
• Reassessing arrangements not initially meeting the contract criteria, as significant changes may occur in the underlying facts and circumstances  
• Assessing management’s and the customer’s commitment and ability to perform under the contract  
• Checking that payment terms are properly considered  
• Assessing the collectibility criterion  
• Evaluating contract modifications |
| **Step 2: Identify Performance Obligations** | • Identifying performance obligations, including those explicitly stated in the contract and those that may be implied based on customary business practices  
• Evaluating whether a promised good or service is distinct, particularly within the context of the contract  
• Evaluating whether a series of goods or services should be treated as a single performance obligation |
| **Step 3: Determine the Transaction Price** | • Estimating the amount to which the entity expects to be entitled, *i.e.*, the transaction price, including any variable consideration. When valuation consultants are hired, it normally is expected that controls are in place to help ensure their competence and objectivity  
• Evaluating whether any portion of variable consideration should be constrained  
• Determining the FV of noncash consideration  
• Identifying and measuring whether there is a significant financing component in the contract  
• Determining the accounting for consideration payable to a customer |
| **Step 4: Allocate the Transaction Price** | • Estimating the standalone selling price, including the increasing of observable inputs in that process  
• Determining the appropriate transaction price allocation, including variable consideration and discounts |
| **Step 5: Satisfaction of Performance Obligations** | • Determining whether performance obligations are satisfied at a point in time or over time  
• Measuring progress toward complete satisfaction of a performance obligation that is satisfied over time, *i.e.*, the input and output methods  
• Recognizing revenue only when (or as) control is transferred to the customer |
## Appendix B – Disclosure Requirements

<table>
<thead>
<tr>
<th>Description</th>
<th>Public¹ Entities</th>
<th>All Other Entities</th>
<th>Annual</th>
<th>Interim (Public¹ Entities Only)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contracts with Customers</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue recognized from contracts with customers, separate from other sources of revenue</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td>Any impairment loss on any receivable or contract assets arising from a contract with a customer, separate from impairment losses on other contracts</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td><strong>Disaggregation of Revenue</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>An entity shall disaggregate revenue recognized from contracts with customers into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>An entity shall disclose sufficient information to enable the users of financial statements to understand the relationship between the disclosures of disaggregated revenue and revenue information that is disclosed for each reportable segment, if the entity applies Topic 280</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td><strong>Disaggregation Practical Expedient for Private Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonpublic entities electing not to disclose the quantitative disaggregation information above shall disclose, at a minimum, revenue disaggregated according to the timing of transfer of goods or services and qualitative information about how economic factors affect the nature, amount, timing and uncertainty of revenue and cash flows</td>
<td>N/A</td>
<td>YES</td>
<td>YES</td>
<td></td>
</tr>
<tr>
<td><strong>Contract Balances</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening and closing balances of receivables, contract assets and liabilities from contracts with customers, if not otherwise separately presented or disclosed</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Revenue recognized in the reporting period that was included in the contract liability balance at the beginning of the period</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
</tbody>
</table>

¹ The new revenue standard defines a public entity as any one of these:
- A public business entity
- An NFP entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC
## Contract Balances

<table>
<thead>
<tr>
<th>Description</th>
<th>YES</th>
<th>NO</th>
<th>YES</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate transaction price allocated to unsatisfied or partially satisfied performance obligations at the end of the reporting period(^2)(^3)</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Explanation of how the timing of satisfaction of its performance obligations related to the typical timing of payment and the effect those factors have on the contract asset and liability balances; may use qualitative information</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Explanation of significant changes in the contract asset and liability balances during the reporting period</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
<td>YES</td>
</tr>
</tbody>
</table>

### Performance Obligations – Some Practical Expedients Available

<table>
<thead>
<tr>
<th>Description</th>
<th>YES</th>
<th>YES</th>
<th>YES</th>
</tr>
</thead>
<tbody>
<tr>
<td>When an entity typically satisfies its performance obligations</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Significant payment terms (when payment is typically due, existence of significant financing component, any variable consideration, any constraints on variable consideration)</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Nature of goods or services promised, highlighting if entity is acting as an agent</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Obligations for returns, refunds and other similar obligations</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Types of warranties and related obligations</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
</tr>
<tr>
<td>When an entity expects to recognize as revenue the amount disclosed immediately above on either a quantitative basis using the time bands that would be most appropriate for the duration of the remaining performance obligations or using qualitative information(^2)(^3)</td>
<td>YES</td>
<td>NO</td>
<td>YES</td>
</tr>
</tbody>
</table>

---

\(^2\) An entity need not disclose this information for a performance obligation if either condition is met:
  a. The performance obligation is part of a contract with an original expected duration of one year or less.
  b. The entity recognizes revenue in the amount to which the entity has a right to invoice.

\(^3\) An entity need not disclose this information for variable consideration if either condition is met:
  a. The variable consideration is a sales-based or usage-based royalty promised in exchange for a license of intellectual property.
  b. The variable consideration is entirely allocated to a wholly unsatisfied performance obligation or wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation under the series provision.
### If Practical Expedients Are Elected for Performance Obligations

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity shall disclose what optional exemptions it is applying as well as the nature of the performance obligations, the remaining duration and a description of the excluded variable consideration. An entity shall explain whether any consideration is not included in the transaction price and, therefore, not included in the information disclosed, e.g., an estimate of the transaction price would not include any estimated amounts of constrained variable consideration</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity shall disclose if a practical expedient is elected for either the existence of a significant financing component or the incremental costs of obtaining a contract</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Significant Judgments

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Judgments and changes in judgments that significantly affect the amount and timing of revenue from customer contracts. This includes the timing of satisfaction of performance obligations and the transaction price and the amounts allocated to performance obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>For performance obligations satisfied over time:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- The method used to recognize revenue</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Explanation of why the methods used faithfully depict the transfer of goods or services</td>
<td>Yes</td>
<td>Yes</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>For performance obligations satisfied at a point in time, the significant judgments made in evaluating when a customer obtains control of the promised goods or services</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Methods, inputs and assumptions used for:</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determining the transaction price, including estimating variable consideration, adjusting the price consideration for the time value of money and measuring noncash consideration</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assessing whether an estimate of variable consideration is constrained</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allocating the transaction price, including estimating the standalone selling price of promised goods or services and allocating discounts and variable consideration to a specific part of a contract</td>
<td>Yes</td>
<td>No</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Description</th>
<th>Yes</th>
<th>No</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Measuring obligations for returns, refunds and similar obligations</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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**Note:** The table above outlines the disclosures required when practical expedients are elected for performance obligations. Each entry in the table indicates whether the disclosure is required or not, with 'Yes' representing required disclosures, 'No' indicating not required, and 'YES' indicating that the disclosure is required and has been made.