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CONSTRUCTION TODAY

New Standards

Transparency may be the future for construction.

By Hogi Kurniawan

Transparency might be the future for the construction industry, whether developers and contractors want it or not. In order to comply with a new update from the Financial Accounting Standards Board (FASB), more information will have to be shared through additional disclosures, more judgment involved and possibly more oversight will have to be implemented.

While the thought process and terminology will be different under the new standard, revenue recognized under the new standard may be similar to current practice. Entities will be required to select an input method (such as cost-to-cost method) or output method (such as units-produced or units-delivered) to measure the progress of each contract and determine the amount of revenue recognized.

It should be noted the new standard states that common output methods generally do not capture progress on unfinished units and as a result, may not represent the most accurate method to measure progress. In addition, revenue under the new standard focuses more on when a performance obligation is satisfied, which occurs when control of a good or service transfers to the customer. Control can transfer either at a point in time or over time. Many construction-type contracts will transfer control of a good or service over time and therefore might result in a similar pattern of revenue recognition as today's guidance. This should not, however, be assumed.

Another factor of consideration would be the performance obligations in the contract, which are promises to deliver goods or perform services. Contractors often account for each contract at the individual contract level today regardless whether each contract may contain multiple promises for a variety of goods and services. Current guidance permits this approach. Determining when to separately account for these performance obligations under the new standard will require judgment.

It is possible to account for a contract at the contract level under the new standard when the criteria for combining a bundle of goods or services into one performance obligation are met. Judgment will be needed, particularly when assessing contracts such as engineering, procurement, and construction (EPC) or design / build contracts.

Existing construction contract guidance requires a contractor to record an asset for unbilled accounts receivable when revenue is recognized but not billed. The unbilled accounts receivable is transferred to a billed accounts receivable when the invoice is processed. Under the new standard, if a contractor delivers services to a customer before the customer pays, the contractor should record either a contract asset or a receivable depending on the nature of the contractor's right to consideration for its performance (i.e. when the contractor has a right to payment). This may not coincide with the timing of the invoice as is required under the existing guidance.

The new guidance offers a comprehensive disclosure requirement that mandates entities provide users with detailed financial statements on existing contracts with customers. This increased requirement will impact contractors significantly as they will now be expected to provide more detailed information regarding contacts with customers. Some of the disclosures that may be new to certain entities include:

• Disaggregation of revenue into categories to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors.

• Extensive disclosure on contract balances to enable users to understand the relationship between the revenue recognized and changes in overall balances of total contract assets and liabilities.

• If applicable, the standard requires that the disclosure of information about assets recognized from the costs to obtain or fulfill a contract. These disclosures are intended for explaining the types of costs recognized as assets (e.g., sales commissions).

This is likely the most significant impact the updated standards will have on the industry even if the revenue recognized by entities does not change under the new standards, and will require companies to comb through all customers' contracts to identify and report on an expanded amount of contractual details pertaining to the nature, amount, timing and uncertainty of revenue and cash flows arising from those contracts. Disclosures such as this could drastically reshape the company's financial statements. It presents an additional responsibility for the upper management charged with reviewing this new information, but nonetheless they will become an essential part of the financial statements.

In summary, the FASB's new revenue standards will supersede the existing guidance. To comply with the new standards, construction companies are advised to educate themselves on the following key five steps under the new standards:

1. Identify the contract(s) with a customer

2. Identify the performance obligations in the contract

3. Determine the transaction price

4. Allocate the transaction price to the performance obligations in the contract

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

The process by which revenue is recognized may not change under the new standards. Nevertheless, much attention needs to be paid to these new rules. Chief executives and CFOs should reassess the way they run their companies and many may have to develop new or modify existing procedures and business practices to achieve compliance under the new revenue standards.

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