

Financial Reporting Center – Revenue Recognition

Working Draft: Engineering & Construction Contractors Revenue Recognition Implementation Issue



Issue #4-1: Identifying the Unit of Account

Expected Overall Level of Impact to Industry Accounting: Significant

Wording to be Included in the Revenue Recognition Guide:

1. Identifying the unit of account for purposes of accounting, for revenue and costs, involves identifying the contract(s) with the customer and identifying the performance obligations in the contract.

Identifying the contracts with the customer.

2. FASB ASC 606-10-25-9 discusses the criteria for when two or more contracts entered into at or near the same time with the same customer should be accounted for as a single contract.

Identifying the performance obligations in the contract.

3. FASB ASC 606-10-25-14 to 25-22 discuss how to determine whether promised goods and services in the contract represent performance obligations.
4. FASB ASC 606-10-25-14 establishes that a contractor should assess goods or services promised in a contract and identify as performance obligations each promise to transfer to the customer either:
 - a) A good or service (or bundle of goods or services) that is distinct; or
 - b) A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
5. FASB ASC 606-10-25-15 explains that a series of distinct goods or services has the same pattern of transfer to the customer if both the following criteria are met:
 - a) Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time; and
 - b) In accordance with ASC 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

6. Determining whether goods and services are distinct is a matter of judgment. While FASB ASC 606-10-25-19(a) effectively looks to the economic substance of each good or service to determine whether a customer can benefit from that good or service either on its own or with readily-available resources or those available to the customer in the marketplace, ASC 606-10-25-19(b) requires the contractor to evaluate whether the promised good or service *in the contract* is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract) and ASC 606-10-25-21 provides a non-exclusive list of indicators for the contractor to consider. A contractor's evaluation of the indicators may vary depending on the specific circumstances of the contract.
7. In many engineering and construction contracts, the finished deliverable is constructed in a number of phases (for example, front-end engineering & design, detailed engineering, procurement, fabrication, construction or construction management, and validation or start-up) that each include goods or services that normally provide benefit to the customer on their own or together with other readily available resources. Therefore, the contractor's evaluation regarding whether a promised good or service is or is not distinct will likely depend more on an evaluation of the criteria in FASB ASC 606-10-25-19(b), that is, whether those goods or services are distinct within the context of the contract.
8. FASB ASC 606-10-25-21 includes factors for consideration in determining whether a contractor's promise to transfer a good or service to a customer is or is not separately identifiable; however, it does not limit a contractor's consideration only to those factors identified. As a result, an entity's evaluation of the indicators in ASC 606-10-25-21 will be largely driven by the nature of the transaction and the specific facts and circumstances of the contract.
9. BC 105 of ASU 2014-09 explains that the principle of "separately identifiable" is based on the notion of separable risks; that is whether the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services. BC 106 of ASU 2014-09 further notes that the factors in ASC 606-10-25-21 are based on the same underlying principle of inseparable risks, and that in many cases more than one of the factors might apply to a contract with a customer.
10. The factor in FASB ASC 606-10-25-21(a) suggests that a promised good or service in a contract is not distinct from the other promised goods or services where the contract is for the construction of a single, combined output resulting from the contractor's significant service of integrating the component goods and services in the contract. FinREC believes that an important factor for determining that goods or services should be combined with an integration service into a single performance obligation is that the risk the entity assumes in performing the integration service is inseparable from the risk relating to the transfer of the other promised goods or services. The judgment about the risk an entity assumes with respect to a promised good or service can often be inferred by certain terms of the contract, such as the contract's acceptance or warranty provisions. For example, if the contract specifies that the entity is warranting that a promised good or service will meet certain specifications, then it may suggest that an output of the contract is that particular good or service.
11. Another important judgment in interpreting FASB ASC 606-10-25-21(a) is whether the integration service is significant. BC 107 of ASU 2014-09 states that the risk of transferring individual goods or services is inseparable from an integration service because a *substantial* part of the entity's promise to a customer is to ensure the individual goods or services are incorporated into the combined output. BC 107 continues to explain that this factor may be relevant in many construction contracts in which the contractor provides an integration (or contract management) service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks.
12. An integration service may be clearly evident when combining a number of subcomponents into a single deliverable (e.g., construction of a single structure). However, many E&C contracts are for the provision of multiple services and/or structures (such as engineering and construction of a power generation facility). In these arrangements, additional judgment will be required when evaluating whether there is a substantial integration service involved. While there is generally assumed to be a significant service of integrating engineering with construction to produce a combined output (such as a power plant), FinREC believes in some circumstances the engineering may not be significantly integrated with the construction (such as when engineering and construction

are performed in separate and distinct phases for which the customer has the option of awarding construction to a different contractor upon completion of the engineering). Significant judgment is required in making this assessment, and the conclusion should be based on specific facts and circumstances. Careful consideration should be given to the degree of the integration service provided in the context of the contract.

13. For example, if an engineering and construction company has a subsidiary that provides fabrication services, whether the fabrication services would be a separate performance obligation from construction in a contract would depend on the significance of the integration service. If the fabrication subsidiary is fabricating major sections of a bridge in its own fabrication yard and a substantial part of the construction services involves constructing the bridge by installing the fabricated components to produce the combined output of a single bridge, the fabrication and construction should be considered a single performance obligation if the entity concludes that the risk of fabrication of the individual components of the bridge is inseparable from the risk associated with construction of the bridge.
14. The factor in FASB ASC 606-10-25-21(b) suggests that a promised good or service in a contract is not distinct where it significantly modifies or customizes another good or service in the contract. Within the construction industry, typically engineering significantly modifies or customizes each construction project. For example, the construction would be customized because of site condition differences at each location, based on the engineering, for what might otherwise be identical power generation facilities.
15. The factor in FASB ASC 606-10-25-21(c) explains that a promised good or service in a contract is not separately identifiable if it is highly dependent upon, or highly interrelated with, other promised goods or services in the contract. BC 111 of ASU 2014-09 indicates that this indicator was included because, in some cases, it might be unclear whether the entity is providing an integration service or whether the goods or services are significantly modified or customized. It is usually clear whether the factors in FASB ASC 606-10-25-21 (a) and (b) are met for engineering and construction contracts; therefore, the factor in (c) will typically be less important in making the assessment of whether promised goods or services in the contract are not separately identifiable.
16. If after having considered the factors in FASB ASC 606-10-25-21 a contractor has determined that promised goods or services are distinct, the contractor would then consider whether those distinct goods or services are substantially the same and have the same pattern of transfer to the customer (ASC 606-10-25-14(b)). In making this determination the contractor would evaluate whether the following criteria from ASC 606-10-25-15 are met:
 - a) The distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time; and
 - b) The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
17. BC 113 of ASU 2014-09 explains that the criteria in FASB ASC 606-10-25-15 were included as part of the definition of performance obligation to simplify the application of the model and to promote consistency in the identification of performance obligations in circumstances in which the entity provides the same good or service consecutively over a period of time. BC 114 identifies several examples of repetitive service contracts, including a cleaning contract, transaction processing or a contract to deliver electricity. Within the E&C industry, an example of a series of services would be an operations and maintenance contract with a manufacturing customer for maintenance services that are substantially the same from day to day.
18. The following example is meant to be illustrative, and the actual determination of the performance obligation(s) in the contract should be based on the facts and circumstances of an entity's specific situation.

Example 1: Illustration of ASC 606-10-25-19 to 25-21 – Identifying Performance Obligations - Design, Build and Maintenance Contract.

E&C Corporation (the contractor) has entered into a contract with State Transit Authority (the customer) to design and construct a commuter rail line, and maintain this line along with other lines that are already operational. The maintenance services consist of regularly-scheduled maintenance of the rail lines; major overhaul services are not within the scope of this contract. The design and construction work is expected to take five years to complete. The maintenance of the other lines that are already operational will be transitioned from being performed in-house

by State Transit Authority to E&C Corp. within one year and the maintenance portion of the contract will continue for 20 years.

E&C Corp. reviews ASC 606-10-25-19 to 25-21 to identify the performance obligations in this contract. E&C Corp. determines that there are two performance obligations in this contract – one being the design and construction activity and the other being the maintenance activity, which is a series of distinct services in accordance with ASC 606-10-25-14 (b).

E&C Corp. concludes that each of the promises in the contract (design, construction, and maintenance services) is capable of being distinct in accordance with ASC 606-10-25-19(a). That is, the customer can benefit from the goods and services either on their own or together with other readily available resources. This is evidenced by the fact that other entities regularly sell these services separately to other customers (i.e., the customer could receive the design services from one entity and separately contract for the construction or maintenance services from another entity).

However, E&C Corp. concludes that the design and construction services are not separately identifiable (i.e., distinct within the context of the contract) in accordance with ASC 606-10-25-19 (b). This conclusion was reached by considering the indicators in ASC 606-10-25-21. That is, E&C Corp. provides a significant service of integrating the design and construction services into a single output for which the customer has contracted (a commuter rail line). Additionally, the design significantly modifies or customizes construction, and construction is highly interdependent on the design. Therefore, as both criteria in ASC 606-10-25-19 are not met for the design and construction services, E&C Corp. concludes that they should be combined into one performance obligation.

In determining whether the maintenance service is distinct from the design/construction, E&C Corp concludes that the maintenance services are separately identifiable from the design and construction services in the contract itself (ASC 606-10-25-19(b)). That is, the maintenance services are not highly integrated with or highly dependent on the design/construction and do not significantly modify or customize the design/construction (606-10-25-21). Additionally, the maintenance services are determined to be a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer, in accordance with ASC 606-10-25-14(b) and 25-15. E&C Corp., therefore, determines that the maintenance services are a series of distinct goods and services accounted for as a single performance obligation and distinct from the design/construction services performance obligation.

Comments should be received by September 1, 2016, and sent by electronic mail to Fred Gill at fgill@aicpa.org, or you can send them by mail to Fred Gill, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.

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