

Financial Reporting Center – Revenue Recognition

Working Draft: Engineering & Construction Contractors Revenue Recognition Implementation Issue



Issue #4-3: Acceptable Measures of Progress

Expected Overall Level of Impact to Industry Accounting: Significant

Wording to be Included in the Revenue Recognition Guide:

Measuring progress toward complete satisfaction of a performance obligation

1. In measuring progress toward complete satisfaction of a performance obligation, paragraph 25-31 of FASB ASC 606-10, *Revenue from Contracts with Customers* states that, the objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).
2. As discussed in FASB ASC 606-10-25-33, there are various appropriate methods of measuring progress that are generally categorized as output methods and input methods. FASB ASC 606-10-55-17 explains that output methods include surveys of performance completed to date, appraisals of results achieved, milestones reached, and units produced or units delivered. FASB ASC 606-10-55-20 explains that input methods include resources consumed, labor hours expended, costs incurred, time lapsed, or machine hours used relative to the total expected inputs to the satisfaction of that performance obligation. Considerations for selecting those methods are discussed in paragraphs 55-16 through 55-21 of FASB ASC 606-10. As required in FASB ASC 606-10-25-32, for each performance obligation, the entity shall apply a single method of measuring progress that is consistent with the objective in FASB ASC 606-10-25-31 and shall apply that method consistent with similar performance obligations and in similar circumstances.
3. For engineering & construction entities, a careful evaluation of the facts and circumstances is required to determine which method best depicts the entity's performance in transferring control of goods or services to the customer. The entity should carefully consider the nature of the product or services provided and the terms of the customer contract, such as contract termination rights, the rights to demand or retain payments, and the legal title to work in process in determining the best input or output method for measuring progress toward complete satisfaction of a performance obligation.

United States Federal Government Contracts

4. Engineering and construction contracts with the United States federal government typically provide the government the ability to terminate a contract for convenience, which is the unilateral right to cancel the contract whenever the federal buying agency deems the cancellation is in the public interest. Under a termination for

convenience clause, the contractor generally is entitled to recover all costs incurred to the termination date, plus other costs not recovered at termination (such as ongoing costs not able to be discontinued, for example, rental costs) as well as an allowance for profit or fee. The U.S. federal government also typically has the right to the goods produced and in-process under the contract at the time of a termination for convenience.

5. FASB ASC 606-10-55-17 states:

An output method would not provide a faithful depiction of the entity's performance if the output selected would fail to measure some of the goods or services for which control has transferred to the customer. For example, output methods based on units produced or units delivered would not faithfully depict an entity's performance in satisfying a performance obligation if, at the end of the reporting period, the entity's performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output.

6. BC165 of ASU 2014-09 further notes that:

In the redeliberations, some respondents, particularly those in the contract manufacturing industry, requested the Boards to provide more guidance on when units-of-delivery or units-of-production methods would be appropriate. Those respondents observed that such methods appear to be output methods and, therefore, questioned whether they would always provide the most appropriate depiction of an entity's performance. The Boards observed that such methods may be appropriate in some cases; however, they may not always result in the best depiction of an entity's performance if the performance obligation is satisfied over time. This is because a units-of-delivery or a units-of-production method ignores the work in process that belongs to the customer. When that work in process is material to either the contract or the financial statements as a whole, the Boards observed that using a units-of-delivery or a units-of-production method would distort the entity's performance because it would not recognize revenue for the assets that are created before delivery or before production is complete but are controlled by the customer.

7. A distinction between the cost-to-cost method and an output method such as units-of-delivery is that the cost-to-cost method includes work in process in the measurement towards complete satisfaction of the performance obligation.

8. A termination for convenience clause that gives the customer the right to the goods produced and in-process under the contract at the time of termination may indicate that the customer has effective control over the goods produced and work-in-progress, even if not in the customer's physical possession. FinREC believes in these circumstances an output method, such as units-of-delivery or units-of-production, would not be an appropriate measure of the progress toward complete satisfaction of the performance obligation since an output method would ignore the work in process that belongs to the customer as discussed in BC 165 of ASU 2014-09. Therefore, an input method would typically be more appropriate in these circumstances.

9. Accordingly, the engineering and construction entity would evaluate their specific circumstances to determine if an input method, such as cost-to-cost, is an appropriate measure of the progress toward complete satisfaction of the performance obligation that faithfully depicts the activity for which control is transferred to the customer.

Engineering & Construction Service Contracts

10 As the nature of engineering and construction service contracts varies widely, the selection of the best method of measuring progress toward complete satisfaction of a performance obligation requires knowledge of the services provided to the customer as well as the contractual terms of the performance obligation, particularly those terms involving the timing of service delivery.

11 FASB ASC 606-10-55-18 states that, as a practical expedient, if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date (for example, a service contract in which an entity bills a fixed amount for each hour of service provided), the entity may recognize revenue in the amount to which the entity has a right to invoice.

12 An engineering and construction company should consider if the practical expedient in FASB ASC 606-10-55-18 would be applicable for its service contracts that specify the right to invoice an amount that corresponds directly with the value to the customer of the entity's performance completed to date. The practical expedient may be appropriate, for example, for an operations and maintenance contract when the amounts invoiced to the customer are based on labor hours incurred.

- 13 There are times when this practical expedient may not be appropriate. If a maintenance service contract has variable consideration, such as a significant incentive provision which is assessed and paid by the customer only once or infrequently (upon achievement of contractual milestones, upon contract completion or only once each year) or with a fixed price lump-sum construction contract, FinREC believes recognition of revenue based on the right to invoice, may not be appropriate. In addition, because many engineering, procurement and construction contracts result in the “delivery” of an integrated set of outputs (i.e., a functioning power plant) and the value transferred to date during the project may not correspond directly to the right to consideration from the customer, the use of the practical expedient in FASB ASC 606-10-55-18 may not be appropriate.
- 14 For certain service contracts it may be appropriate to use input methods, such as cost-to-cost or labor hours expended, for measuring progress towards complete satisfaction of a performance obligation depending on the facts and circumstances. FASB ASC 606-10-55-20 states that, if the entity’s efforts or inputs are expended evenly throughout the performance period, it may be appropriate for the entity to recognize revenue on a straight-line basis. FinREC believes the straight-line basis would be expected to be used in limited circumstances in the construction industry. Since most performance obligations in engineering and construction contracts are not satisfied evenly throughout the performance period, the cost-to-cost input method may be more appropriate.
- 15 For other service contracts, it may be appropriate to use an output method related to the number of instances homogeneous services are provided to the customer relative to the number of instances the services are expected to be performed over the life of the service contract.
- 16 The following examples are meant to be illustrative of engineering and construction service contracts that management has determined to be a single performance obligation, and the actual determination of the method for measuring complete satisfaction of a performance obligation as stated in ASC 606-10-25-31 should be based on the facts and circumstances of an entity’s specific situation.
- Example 1: An engineering and construction company provides daily maintenance services for a manufacturing facility. These services qualify as a series of distinct services that are substantially the same and that have the same pattern of transfer in accordance with FASB ASC 606-10-25-14(b). The company bills monthly for the labor and material costs. The contract has a provision to award and pay an incentive bonus on an annual basis based on certain safety and cost-savings provisions. The criteria in FASB ASC 606-10-32-5 and 606-10-32-11 related to variable consideration for recognition of an estimated amount of the incentive are met. Because of the annual incentive, an input method may be most appropriate (see Section 13).
 - Example 2: A heavy construction equipment company enters into a contract that provides routine maintenance for a fleet of heavy construction equipment for equal monthly payments over 24 months of service. The company’s performance on this contract (as evidenced by costs incurred) occurs evenly over the period. The company may consider a time-based method, such as straight-line revenue recognition, to be a reasonable depiction of the amount of the entity’s performance and transfer of control of the services to the customer since the efforts are expended evenly throughout the performance period (and not because the same amount is paid to the company each month).
 - Example 3: The same heavy construction equipment company, under a different contract with a different customer, provides a major equipment maintenance overhaul on a time and materials basis. In this circumstance, the level of effort necessary for an overhaul and the pattern of performance over time vary depending upon the condition of the equipment. In these circumstances, an input method may be a reasonable depiction of the amount of the entity’s performance and transfer of control of the service to the customer.

Use of Units-of-Delivery Method to Measure Progress

- 17 If the entity determines that revenue should be recognized over time and the customer has control of the goods as the performance occurs, based on the guidance described in paragraph 8 above, a units-of-delivery or units-of-production method that has not been modified to take into account the assets that are created before delivery occurs or production is complete would not result in the best depiction of an entity’s performance because such unmodified methods ignore the work in process for which control has been transferred to the customer. When that work in process is material to the contract, using a units-of-delivery or a units-of-production method would distort the entity’s performance because it would not recognize revenue for the assets that are created before delivery or before production is complete but are controlled by the customer.
- 18 Furthermore, units-of-delivery or units-of-production may not be appropriate for contracts providing design and production services because an equivalent amount of value is not delivered to the customer with each unit. BC166

of FASB ASU 2014-09 states that “the Boards also observed that a units-of-delivery or a units-of-production method may not be appropriate if the contract provides both design and production services because, in this case, each item produced or delivered may not transfer an equal amount of value to the customer”.

- 19 BC166 of ASU 2014-09 goes on to further state that a units-of-delivery method may be an appropriate method for measuring progress for a long-term manufacturing contract of standard items that individually transfer an equal amount of value to the customer on delivery.
- 20 FinREC believes a units-of-delivery method may be appropriate in situations where the entity has a production-only contract, producing homogenous products, and the method would accurately depict the entity’s performance. When selecting a method for measuring progress and considering whether a units-of-delivery method is appropriate, an entity should consider its facts and circumstances and select the method that depicts the entity’s performance and the transfer of control of the goods or services to the customer. For example, for a highway paving contract for which output is cubic yards of pavement laid, a units-of-delivery method may be a reasonable depiction of the amount of the entity’s performance and transfer of control of the goods/services to the customer.

Inputs that Do Not Depict an Entity’s Performance

- 21 Paragraphs 55-20 and 55-21 of FASB ASC 606-10 provide guidance about measuring progress toward complete satisfaction of a performance obligation using input methods. It states that the entity should exclude from an input method the effects of inputs that do not depict the entity’s performance in transferring goods or services to the customer.

Consideration of Significant Inefficiencies in Performance

- 22 For entities using a cost-based input method for measuring progress towards complete satisfaction of performance obligations, an adjustment to the measure of progress may be required in certain circumstances. FASB ASC 606-10-55-21(a) states that, an entity would not recognize revenue on the basis of costs incurred that are attributable to significant inefficiencies in the entity’s performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources which were incurred to fulfill the performance obligation).
- 23 Determining which costs represent unexpected “wasted” materials, labor or other resources requires significant judgment and varies depending upon the facts and circumstances. Engineering and construction projects normally have some areas of expected inefficiencies, and contingencies are included in the original project forecast for these types of risks.
- 24 There are circumstances, however, where unexpected significant inefficiencies may occur that were not considered a risk at the time of entering into the contract, such as extended labor strikes or design or construction execution errors that result in significant wasted resources that may require adjustment to a cost-based input method for measuring progress. These wasted materials should be excluded from the measure of progress towards completion and the costs should be expensed as incurred.

Costs Incurred that are not Indicative of Performance

- 25 There may also be circumstances whereby the cost incurred on an engineering and construction contract is not proportionate to the entity’s progress in satisfying the performance obligation. For example, engineering and construction entities may enter into contracts where they procure equipment and material. The procurement alone of those products likely would not be indicative of the entity’s performance, unless the company has the right to payment for the cost for the procurement plus a reasonable profit such that the procurement itself represents progress towards completion.
- 26 FASB ASC 606-10-55-21 explains that an entity should exclude from an input method the effects of any input that does not depict the entity’s performance in transferring control of goods or services to the customer. ASC 606-10-55-21(b) states that when a cost incurred is not proportionate to the entity’s progress in satisfying the performance obligation, 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. For example, a faithful depiction of an entity’s performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects at contract inception that all of the following conditions would be met:

1. The good is not distinct,
2. The customer is expected to obtain control of the good significantly before receiving services related to the good,

3. The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation,
 4. 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 in accordance with paragraphs 606-10-55-36 through 55-40).
- 27 For these types of contracts, if a contractor is using a cost-based input method for measuring progress towards complete satisfaction of performance obligations and the purchase of the material meets the conditions FASB ASC 606-10-55-21(b), an entity should exclude the costs incurred for the product from the measurement of progress for the performance obligation in accordance with the objective of measuring progress in ASC 606-10-25-31. In such circumstances, progress would be measured based on the other costs. In accordance with the discussion in BC172 of ASU 2014-09, this accounting method would result in zero margin recognition for the purchase of the product and contract margin recognition over the remaining costs incurred to satisfy the 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.