

Financial Reporting Center – Revenue Recognition

Working Draft: Engineering & Construction Contractors Revenue Recognition Implementation Issue



Issue #4-5: Impact of Termination for Convenience on Contract Duration

Expected Overall Level of Impact to Industry Accounting:
Significant

Wording to be Included in the Revenue Recognition Guide:

1. It is common in the engineering and construction industry to have contracts that give the customer a right to cancel for convenience or other than for cause but that do not give the contractor similar rights (or that the contractor could not exercise without incurring significant consequences). Engineering and construction customers include such termination clauses to provide them an opportunity to suspend or terminate a project should unforeseen economic or political circumstances occur that significantly affect the return that would be generated by the capital project. However, unlike in industries where contracts are for much smaller value and for a series of services (for example, cellular phone services), engineering and construction contracts are rarely terminated, because partial completion of a capital project or a facility is of little value to the customer and the customer would incur additional costs that are considered akin to termination penalties (for example, costs of shutting down the work, demobilization, storage and handling of uninstalled materials, as well as restart costs if the customer later desires to complete the project).
2. FASB ASC 606-10-32-4 states: “For the purpose of determining the transaction price, an entity shall assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.”
3. In an engineering and construction contract, the promise to the customer is often a facility or capital asset, as discussed in Issue #4-1 “Identifying the Unit of Account.”
4. At the November 2015 meeting of the FASB/IASB Revenue Recognition Transition Resource Group (TRG), an implementation issue was discussed regarding how to determine the term of the contract when the customer has the unilateral right to terminate a contract, and whether termination penalties affect that analysis.

5. As discussed in paragraphs 50 and 51 of TRG Agenda Ref 48: Customer Options for Additional Goods and Services, Issue 2: Customer Termination Rights and Penalties, the FASB and IASB Staff recommended that contracts with customer termination provisions should be accounted for the same as contracts with unexercised options when the contract does not include a substantive termination penalty. That is, if the termination penalty is not substantive, this may indicate that the contract term in accordance with FASB ASC 606 is less than the stated contractual period. FASB/IASB TRG Agenda Ref 49, November 2015 Meeting – Summary of Issues Discussed and Next Steps, paragraph 10 states, in part:

At the October 31, 2014 TRG meeting, the TRG discussed the accounting for termination clauses in the contract when *each* party has the unilateral right to terminate the contract by compensating the other party. At that meeting, TRG members supported the view that the legally enforceable contract period should be considered the contract period. Since that meeting, stakeholders have raised further questions (Issue 2) about evaluating a contract when only *one* party has the right to terminate the contract. TRG members agreed with the staff analysis that the views expressed at the October 2014 TRG meeting would be consistent regardless of whether both parties can terminate, or whether only one party can terminate. TRG members highlighted that when performing an evaluation of the contract term and the effect of termination penalties, an entity should consider whether those penalties are substantive. Determining whether a penalty is substantive will require judgement and the examples in the TRG paper do not create a bright line for what is substantive.

6. FinREC believes that the contractor's history with terminations for different types of contracts, specific knowledge about the customer, and other facts and circumstances should be considered in assessing the impact of a termination provision on the duration of a contract. The TRG discussion regarding the concept of cancellation rights and renewal options and substantive termination penalties noted in paragraph 4 is applicable in contracts for the provision of a series of recurring goods and services (for example, operations and maintenance contracts). Most engineering and construction contracts are for the design and construction of a facility or capital asset. The contractor has enforceable rights to be compensated for work performed during the execution of the contract and upon termination, the contractor has enforceable obligations to complete the entire facility. FinREC believes that since a contractor has an ongoing enforceable obligation, often backed by a surety bond or letter of credit, to deliver the full scope of work specified in a contract with a customer, until the scope of work is completed or the customer explicitly terminates the contract, the contractor should reflect this obligation in the accounting and disclosure of remaining unsatisfied performance obligations until such time that it is probable that the contract will be terminated.
7. The following examples are intended to be illustrative, and different facts and circumstances may change the conclusion. In each example it is assumed that the contract meets all criteria for existence in accordance with FASB ASC 606-10-25-1.

Example 1:

A customer enters into a contract with an engineering and construction company for the design and construction of a high-tech manufacturing facility. In this example the customer would incur a substantial economic penalty to cancel for convenience (for example, significant wind-down costs would be incurred and a partially completed facility would be of no use to that customer). As a result, FinREC believes the contract price, in accordance with FASB ASC 606-10-32-4, and duration of the contract are determined based on the defined scope in the contract (design and build a high-tech manufacturing facility), as opposed to a service contract, which would have a term based on the passage of time.

Example 2:

A customer enters into a contract for recurring maintenance services with a contractor. The contract is for an indefinite term and includes a termination provision that allows either party to cancel for convenience upon 30 days' notice. The contract states that the customer will compensate the contractor in accordance with the terms of the contract for services provided through the termination date. In accordance with the guidance in paragraph 10 of TRG Agenda Ref No. 49, this contract would be accounted for on a month-to-month basis since there is not a substantial (contractual or economic) termination penalty.

Example 3:

A customer enters into a contract to perform small capital projects at the customer's facilities for a period of three years with an option to renew for another three years. The renewal option is assumed not to represent a material right. There is no termination for convenience clause in the contract. FinREC believes that, at inception, the term of this contract is considered three years since there is no termination for convenience clause (neither party has a right to terminate early except in the case of default).

Comments should be received by August 1, 2017, and sent by electronic mail to Fred Gill at Frederick.Gill@aicpa-cima.com, or you can send them by mail to Fred Gill, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.

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