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Revenue Recognition:
PRACTICAL ASPECTS OF UNINSTALLED MATERIALS

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The new revenue recognition standard (ASC 606, Revenue from Contracts with Customers) affects construction companies in unique ways, particularly in the area of purchased material. How a contractor will account for these costs under the new standard depends on a variety of factors, including how the material is classified, when the customer obtains control of the material, and whether or not the material is installed, designed and manufactured by the contractor.

Determining the Classification of Purchased Material

Transfer of control is an important concept in the determination of revenue and the recognition of costs under the new accounting guidance. Contractors need to follow this guidance to determine the classification of material purchased as either inventory, uninstalled material or contract costs and understand when the materials transfer from one classification to the next. Topic 606 states revenue is recognized when (or as) the customer obtains control of the promised good or service (606-10-25-23). When performance obligations are to be recognized over time, an appropriate driver should be selected to measure the progress of transferring control to the customer. Using the cost-to-cost input method as the driver, progress towards completion is computed based on the costs incurred in a project. Costs that relate directly to a contract include, among other costs, direct materials such as supplies used to provide the promised services to a customer. Direct costs are costs that relate directly to an existing or specific anticipated contract. See Topic 340-40-25-7.

Materials Job Cost Practice Prior to Topic 606

It has been common practice for contractors to charge purchases of materials, even commodity items and supplies to a specific job as they are incurred or purchased. Simply put, any cost incurred with the objective of a contract was immediately charged to job costs and a contract often without consideration of control or ownership. Some contractors, particularly trade subcontractors, maintained inventory of materials common to jobs or to stockpile materials anticipated for future work when cost increases were expected. These inventory items were usually charged to a contract and to job costs when they were transferred to the job site, but the contractor may have used some other trigger to determine when the reclassification from inventory was appropriate. When a contract was completed, the contractor would restore any usable materials back into inventory and reduce contract costs. Contractors that perform fabrication under contracts might have an inventory of raw goods such as dimensional steel or sheet metal. Those goods would be held in inventory until they enter into the fabrication process under a contract.

Topic 606 does not have the intent to change inventory accounting, but it is likely that as companies evaluate their practices for Topic 606 implementation they may determine that their prior accounting practices for materials should be changed and inventories recorded to reflect materials where control has not been transferred to the customer.

How to Apply the Transfer of Control Concept to Materials

Companies cannot properly account for contract costs and revenue without a clear understanding of "transfer of control." As discussed above, a contractor may incur costs for materials and control remains with the contractor for a period. A contractor may incur costs for materials, equipment, services, etc. related to a contract that enhance resources that will be used in satisfying performance obligations in the future (mobilization costs) that is recognized as an asset and amortized into job costs over time (Capitalized Costs to Fulfill a Contract). The contractor may incur costs for common materials that immediately (or in an insignificant amount of time) are transferred to the customer. The contractor may incur costs for customized materials that do not have an alternate use other than the particular contract and generally these items will constitute contract costs. However, the fact that an item meets the specifications of a contract does not necessarily infer that it is therefore a contract cost as incurred. This would be the case if the specifications contained a description of materials that are in the common supply chain.

In applying transfer of control standards, it is imperative that an entity has a thorough understanding of the indicators of control. The entity will normally conclude that control has transferred if ownership has transferred to the customer. The construction industry has a lot of unique laws regarding ownership and rights and obligations that arise from individual state laws as well as common law. In some states, ownership of materials passes to the owner of the real estate (For a subcontractor, the property owner is the customer of the customer) when it is delivered to the project site. In other states, ownership interest arises in the customer's hands when the material supplier obtains the right to impose a material lien on the property (normally at the time of purchase with a disclosure of the target job location – even if the material is delivered to another location). In some states, ownership passes to the customer at either billing or collection. What are the laws applied in the jurisdiction of the contract? It is critical that contractors obtain legal advice regarding ownership interest in construction materials before implementing accounting policies regarding materials.

On the other hand, an incurred cost for materials may be for an item that is customized for the particular contract, does not have an alternative use by the contractor, and the contractor has an enforceable right to payment (this does not necessarily mean it is currently billable but that the contractor would be paid for the unique material if the contract is terminated for convenience). These costs are properly accountable for as contract costs as incurred.

Topic 340-40-25-7 describes costs that relate directly to a contract and replace the prior practice and guidance of superseded Topic 605.

As material costs are incurred, accounting policies and internal controls should be in place to identify –

1. **Materials that are inventory (control not transferred to customer)**
2. **Materials that are contract costs (control transferred to customer)**
3. **Materials that are highly customized with no alternative use (deemed transferred due to rights and obligations under the law or by contract)**
4. **Materials transferred to the customer but not installed**

When utilizing a cost-to-cost input method to recognize revenue and the contractor transfers control of the purchased material to the customer, the contractor is satisfying the performance obligation and the materials are included in the cost to cost revenue measurement.

Some assert that identifying uninstalled materials will be a significant hardship and challenge. The counterargument is that for decades contracts have included provisions for billing rights regarding stored materials (very similar to uninstalled materials) and billing forms such as those of the American Institute of Architects include a line to disclose this item.

In evaluating processes, a prime or general contractor cannot subcontract the acquisition of long-lead time materials to avoid having uninstalled materials. If the subcontractor has significant uninstalled materials that are being billed to the general contractor, those items should be excluded from the prime or general contractor's measure of performance that includes the subcontract. Process and procedures including contractual documents should be considered to create routine identification of these costs. This would also be an appropriate talking point at project evaluation meetings between CFO's and project management when evaluating performance of contracts.

NOTE: If an entity is recognizing revenue over time, it is not acceptable to also record work in process.

When to Record Assets for Costs Incurred

When determining at what point a cost should be included in the progress towards completion computation, contractors must consider the following:

1. For costs incurred in fulfilling a contract with a customer that are within the scope of another Topic (e.g. Topic 330 on inventory), an entity should account for those costs in accordance with that Topic. When purchased materials are not unique to a contract (i.e. can be used on other construction contracts) and the contractor has not transferred control to the customer, these materials would be considered inventory in accordance with ASC 330.

2. Topic 340-40-25-5 states an entity shall recognize an asset from the costs incurred to fulfill a contract only if those costs meet all the following criteria:

    a. the costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved);
    b. the costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) the performance obligation in the future; and
    c. the costs are expected to be recovered.

3. Topic 340-40-25 states an entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.

Costs incurred under (1) through (3) above would result in the contractor recognizing an asset without any recognition of revenue.

Accounting for Uninstalled Materials

Topic 606 states when costs incurred are not proportionate to the progress in satisfying the performance obligation, a contractor should carve out these costs if using a cost-to-cost input method. This may arise when a contractor purchases material for a project and transfers control to the customer but does not incorporate the material into the project. For example, this might happen when the material is segregated at the contractor's shop or shipped to the job site. Control of the material being transferred is evidenced when the customer has legal title, physical possession or significant risk, the customer receives and consumes the benefits of the materials, or when the customer has accepted the asset. See the discussion above regarding indicators of control.

Topic 606-10-55-21 states that when using a cost-based input method, an adjustment to the measure of progress may be required when a cost incurred is not proportionate to the entity's progress in satisfying the performance obligation. It is this concept that should drive the judgement and accounting policies adopted by entities. Does including those uninstalled material costs in the measurement overstate the percent complete? Obviously, it does – but is the overstatement enough for the entity to judge that the overstatement is significant? Topic 606-10-55-21(b) goes on to state that "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 (the uninstalled material) incurred.

Entities need to evaluate their typical procurement and installation practices to determine the circumstances that might arise where the cost of uninstalled materials would create a disproportionate measurement of the percent complete. It is proper to document a threshold that will be consistently applied across all or types of projects in applying this concept.

The intent of this standard is not to identify insignificant amounts of materials at any measurement date resulting in complicating the performance measurement. Topic 606-10-55-21(b)'s second sentence starts with "For example," and follows with a listing of four conditions that, if met, might result in adjustment of the measurement. These conditions were not intended to be bright lines but a non-exclusive listing of some factors that could be considered when an entity is evaluating uninstalled materials on a project or establishing an accounting policy. The objective is to form a judgement of whether including the cost of uninstalled materials creates a disproportionate progress measurement that is significant. This judgement will vary based on entities, type of service, etc. and should not be relegated to a bright-line test that would be applied to all contractors. That is each company should adopt an accounting policy and establish internal controls and procedures to identify the threshold that uninstalled materials will be adjusted in the performance measurement.

If it is determined that the uninstalled materials cause costs incurred to be disproportionate to the entity's progress in satisfying the performance obligation, the contractor should recognize revenue in an amount equal to the cost of those goods. In those circumstances, the contractor should also exclude the costs of the uninstalled materials from costs incurred to date, total estimated costs and the transaction price associated with the remaining costs to be consistent with the cost-to-cost methodology and recognize additional revenue equal to the cost of the uninstalled materials.

See Example 19 at Topic 606-10-55-187 through 192 for the details on how to measure revenue when uninstalled materials are recognized as revenue at cost.

While the four conditions are not to be considered hard and fast rules related to the judgement, we will discuss their application because their evaluation will likely be common to many contractor's facts and circumstance evaluation.

1. "The good is not distinct" – Distinct is defined in Topic 606-10-25-19 and is generally interpreted as being an identifiable performance obligation. In most cases the uninstalled materials will not meet this criteria.

2. "The customer is expected to obtain control of the good significantly before receiving services related to the good" – How does an entity apply the concept of "significantly before" installation? This is a judgment that does not have an industry bright line threshold, but the entity should evaluate its typical facts and circumstances to determine an accounting policy and internal controls to trigger application of this concept. What might that policy look like? If a contractor typically has contracts that last between 9 and 15 months, the policy might be that materials that are expected to be installed more than 60 days after transfer of control (being job costed) will subject the contract to modification of the measurement. Or a policy might be that materials expected to be uninstalled more than 20% of the expected contract duration will trigger application. The judgement requires assessing how long is "significant" for the given contract in the context of distortion of its performance measurement.

3. "The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation" – How much is "significant" in the context of total costs? Again, there is no industry standard to apply but nonetheless the entity should adopt a policy that reflects its facts and circumstances that can be consistently applied across their various contracts. It is most likely that specialty contractors, large self-perform contractors, and industrial contractors will be impacted most frequently with this condition. To get a feel for the scope of applying the significant cost concept, consider Example 19 in Topic 606-10-55-187 through 189. In this uninstalled elevator example, the elevator cost (materials) is 37.5% of the total contract costs – significant. The FASB did not produce an example that was for commodity materials that made up 3% of the total cost and the reason they didn't is because that would not depict their intended objective of showing a significant impact. By example, FASB did not intend to formalize 37.5% as a benchmark but it is at least instructive. In considering when revenue would be overstated by uninstalled materials, contractors should consider factors other than the absolute cost of the goods. When uninstalled materials are excluded from performance measurement, revenue is recognized on all the other contract performance plus the cost of the installed materials. If this concept is applied, how much revenue recognition is deferred until installation? The answer is only a portion of the gross profit that would otherwise be recognized on the uninstalled material. If the contract has a 4% gross profit vs. a 30% gross profit, the judgement about the understatement policy threshold would appropriately be set at higher levels of uninstalled materials. Another factor to consider is the overall project level of completion during the time between transfer of control

and installation of the materials. As described in the following section, the profit margin that attributes to the uninstalled materials is associated with the remaining costs. So, if the performance obligation is 40% complete excluding the uninstalled materials, 40% of the profit that associates with the uninstalled materials is recognized in the computation of revenue associated with the remaining contract costs. Therefore, the overstatement that would exist if the entity included the materials in the performance measurement would be 60% of the gross profit margin associated with the uninstalled materials. If the uninstalled materials are on the job on day 1, the overstatement would be 100%. There may be other factors an entity would consider in addition to the ones described in 606 and mentioned herein that would be appropriate for the contractor. Topic 606 instructs entities to assess whether the performance will include significant uninstalled materials at the beginning of the contract. If they exist at that time, the measurement should reflect the carve-out of the estimated uninstalled materials immediately. If the contractor did not foresee significant uninstalled materials but they arise later in the performance, the entity should start the proper measurement at that time with any cumulative catch-up adjustment.

Note that the judgement about the thresholds that would trigger assessment of uninstalled material levels that might include the two significant criteria listed in Topic 606 and are measures of significance at the contract level and not a materiality test. The key for implementation is to create policy thresholds that operationalize the standard so both the scheduling, purchasing, field operations, risk management, and accounting know when it will arise and have processes in place to quantify the materials during the period that they impact measurement of progress.

Accounting for Installed Materials

If revenue was initially recorded equal to cost upon receipt of the item, the contractor needs to determine the appropriate accounting once that item is installed in the project.

In some cases it may be appropriate to include the cost of the materials in the cost-to-cost calculation as the materials are installed (resulting in a cumulative catch-up adjustment representing margin on the performance of the installation), if doing so would result in a faithful depiction of the progress made toward satisfaction of the performance obligation. This may be the case, for example, when a large amount of pipe, conduit or copper wire is installed over an extended period.

In other cases, it may be appropriate to exclude the costs from the cost-to-cost calculation for the entire duration of the contract, if including the costs in the cost-to-cost calculation might result in a distortion of the progress made toward satisfaction of the performance obligation in a single accounting period. This might be the case if a single asset that is significant to the overall contract is installed at a single point in time. See Topic 606 Example 19.

Determining the amount and timing of revenue recognition as costs are incurred for uninstalled materials requires judgment by the contractor based upon the facts and circumstances present in each contract.

Accounting for Goods Designed and Manufactured by the Contractor

If the contractor is significantly involved in the design and manufacturing of an item, even if procured from a third party, then the procurement of the good would represent progress toward satisfying a performance obligation. An example of this is when an engineering and construction company designs materials that are fabricated for a specific project by a third party, such as prefabricated concrete walls of a nuclear power plant

The cost of procurement would be a faithful depiction of the contractor's performance and, therefore, a valid cost to be considered in measuring progress towards completion of the contract. An additional item to be considered includes the contractor's right to payment in the event of termination for convenience by the customer.

Consider the facts of contractors such as HVAC, structural steel, pre-stressed concrete, etc. that enter into a contract to fabricate and install materials. Typical contractual terms require the entity to convert specifications into shop drawings that are approved by the prime contractor and/or engineering. Additionally, the entity may have been part of a BIM team that participated in testing the constructability of the concept or design plans. These activities are elements of design that should be considered. Under their contract, the entity will then fabricate (manufacture) the components to be installed on the project. The entity determines that the process of developing shop drawings, fabrication, and installation are properly accounted for under Topic 606 as a single performance obligation. The fabrication may be required by contract to be completed well in advance of the installation to avoid delays in the overall project schedule. The fabricated components are stored at the contractor's yard because there is insufficient space at the construction site. These contracts typically provide for progress billings by the company during the fabrication phase. It would not be appropriate for the entity to exclude the uninstalled materials from their performance measurement.

Measuring Progress

A regular and persistent occurrence of uninstalled materials impacting the measurement of progress may be an indicator that the entity has not adopted the appropriate method to faithfully depict the entity's performance toward complete satisfaction of the performance obligation. Using a performance measure that does not include material cost will eliminate the need to consider the existence of uninstalled materials.

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