Feature

FDOT Prequalification Requires 2019 Financial Statement Changes

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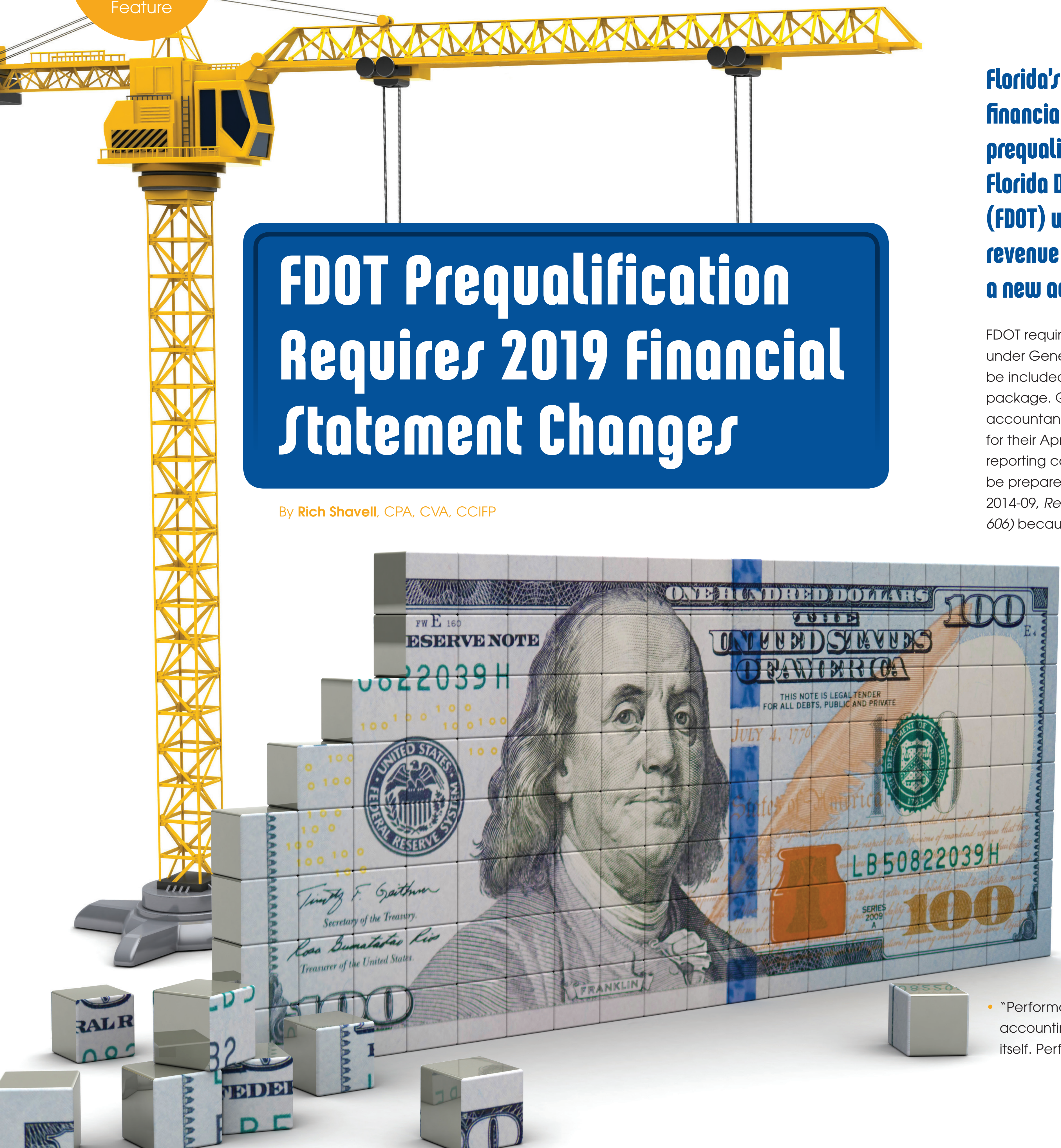

Florida's contractors who submit 2019 financial statements with their annual prequalification application to the Florida Department of Transportation (FDOT) will need to address the new revenue recognition rules required by a new accounting standard.

FDOT requires that an annual financial statement prepared under Generally Accepted Accounting Principles (GAAP)[1] be included with the contractor's annual prequalification package. GAAP is like the "building code" by which accountants prepare financial statements. Therefore, for their April 30, 2020 submission to FDOT, contractors reporting calendar year 2019 financial results will need to be prepared for the changes under Standards Update 2014-09, *Revenue from Contracts with Customers (Topic 606)* because this is the "new GAAP."

Topic 606 technically replaces the percentage-of-completion method (PCM) of accounting, which has been the promulgated methodology for reporting long-term contracts for GAAP since 1981. While Topic 606 technically replaces PCM, most of the PCM methodology is still utilized under Topic 606. There is now a series of adjustments required before applying the familiar methodology.

For example, here are a few of the more significant differences between legacy and the new GAAP:

- Unpriced (unsigned) change orders can be estimated and the gross profit recognized under the new standard. Generally, legacy GAAP does not permit recognition of profit until the amount is known and agreed, i.e. when the change order is signed.
- "Performance Obligations," a new term, is now the accounting unit to be measured rather than the contract itself. Performance Obligations are a segment of the total contract and definitional issues can be confusing.
- "Variable consideration" is another new term, whereby there are new opportunities to accelerate income for contractual contingencies such as bonuses, claims, incentives and back charges, in addition to those pending unsigned changes impacting scope and/or price.
- Footnote disclosures are expanded.
- Balance sheet categories and nomenclature have changes.

Topic 606 Defined

The new GAAP standard specifies that revenue should be recognized based upon this core principle:

> An entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Topic 606 creates a five-step framework for entities to determine when and how much revenue should be recognized:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

For commercial contractors, Step 1: "Identifying the contracts with their customers," as compared to say the IT industry, is generally easy. If a public-private partnership is involved, this may involve some complexity.

Step 2 was a concern when the standard was originally drafted because it seemed there would be many performance obligations for each contract. Under the final version of the rules, the typical contract, when evaluated, may have only one bundle of distinct goods and services. If there is a single performance obligation, results may in some circumstances be very similar to the PCM.

However, change orders may add complexity as there are multiple possibilities for accounting purposes. Accounting now depends on whether the new goods and services are "distinct" from the goods and services in the original contract, such as:

A. In many situations, the change order is treated as a continuation of the original contract, i.e. similar to what is done under the PCM whereby the contract continues and all amounts are treated on a "catch-up" basis; or

B. Solely for accounting purposes, the change order is treated as a new contract; or

C. Solely for accounting purposes, the original contract is treated as though it was terminated and the change order, along with the remaining balance of the original contract, is carried forward.

While "A" and "B" may be familiar for contractors, "C" requires new and unique accounting compared to legacy GAAP. Moreover, analyzing whether goods and services are "distinct" under the rules can be confusing.

Step 3 is where contractors may find opportunities to accelerate income. Variable consideration is evaluated and it is determined how much, if anything, should be included in the "transaction price." This "transaction price" is different from what we currently think of as the contract value under the PCM.

Step 4 is the allocation of the transaction price (determined under Step 3) to the various performance obligations (Step 2). If there is only one performance obligation there is no need for an allocation.

Step 5 is the recognition of revenue, and for many will be similar to the percentage computations under the PCM. But there will be several modifications to consider. For example, uninstalled materials and other costs may need to be excluded from costs-to-date and, in some cases, from the transaction price. For certain types of incurred costs, the impact is that gross profit may not be currently recognized, but is delayed.

Why the Required Change?

The first question we hear from contractors is "why?" Why would a change like this be required? The answer is not something anyone really wants to hear. The U.S. Securities and Exchange Commission (SEC) pressed the accounting folks who set accounting standards to get all businesses reporting revenue under one set of rules, rules that are similar to what is being done for international companies. The reason for the change has nothing to do with a private construction company.

Insidiously, these standards setters chose not to exclude private companies from the now-standardized revenue recognition rules. So, until financial statement users like sureties, banks and agencies, such as FDOT, choose to accept statements under a reporting framework other than GAAP, commercial contractors will need to comply with Topic 606.

Issues for Consideration

One of the questions we ask contractors is whether they plan to change internal reporting for the new standard. We find that most contractors are planning to treat the new reporting requirements as a year-end adjustment. That is, they intend to maintain their internal books as they have in the past and compute the variances at year-end to adjust the books solely for financial statements and then reverse the adjustments so they can continue internal reporting on a consistent basis. For others, this may prove to be a difficult issue. In some cases, contractors provide users of their statements periodic reporting on a monthly or quarterly basis. And now comes the end of the year, where their audited or reviewed financial statements reflect a different basis of reporting, i.e. Topic 606 versus legacy PCM. This will require communication and likely the need to reconcile the variances from interim reporting to year-end.

Another issue causing contractor consternation is that the variances between legacy GAAP (traditional PCM) and the new GAAP rules under Topic 606 may not, in the aggregate, be significant. That's what some of the publicly traded construction companies discovered when they implemented the changes to their 2018 year-end statements[2]. Non-publicly traded commercial contractors will very likely – in many cases – get to a similar result; that is, after implementation of the new standard the variances compared to old GAAP may not be significant. Also, depending on the mix of contracts, contractors with shorter contracts straddling one fiscal year-end may see modest – not significant – timing differences between the two years.

Time to Get Ready

If you require a GAAP statement, you'll need to be prepared by transitioning your reporting to the new standard. Plan ahead to be ready for when your outside CPAs or auditors arrive in early 2020.

Rich Shavell has spent the last 30 years serving the commercial construction industry and all types of contractors. Shavell & Company, P.A. is a Florida-based full-service certified public accounting and consulting firm offering a comprehensive array of tax and accounting services for businesses of all sizes. Shavell & Company helps contractors with bonding maximization, tax structuring and planning, litigation support, business valuation, cash flow analysis and cost segregation studies.

Shavell is an author of the Income Recognition chapter in "Financial Management and Accounting for the Construction Industry," published by Matthew Bender Elite Products. He has testified six times before Congress and five times before the IRS on legislation and proposed regulations impacting the Construction Industry. Shavell is a four-time winner of the South Florida Business Journal *awards for accountants in construction, real estate and tax categories. For more information on Shavell & Company, P.A. or accounting issues, email info@shavell.net or call 561.997.7242*

References:

[1] Rule Chapter 14-22 at 14.22.002(h)(2) reads: "Financial statements shall be prepared in accordance with Generally Accepted Accounting Principles (GAAP)."

[2] Public companies were required to initially report under the new standard for 2018 - not 2019.

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