DISTORTIONS FOR CONSTRUCTION CONTRACTORS: IMPLICATIONS OF REVISED REVENUE RECOGNITION STANDARDS

Gregory S. Kordecki, Clayton State University, Morrow, GA 30260, GregKordecki@Clayton.edu
Maria L. Bullen, Clayton State University, Morrow, GA 30260, MariaBullen@Clayton.edu

ABSTRACT

As every seasoned accountant knows, there are acceptable variations in revenue recognition practices between industries. In fact, the accrual method has not been generally accepted under U.S. generally accepted accounting principles for construction contractors, where in most cases, the percentage-of-completion method should be applied. This paper addresses the historical antecedents for revenue recognition by construction contractors, efforts by the FASB and IASB to arrive at a satisfactory convergence project on the issue of revenue recognition, and the problems associated with implementation of a new revenue recognition standard for construction contractors in the United States.

INTRODUCTION

The convergence approach by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) has some limited success with the financial instruments project, but in some other areas such as leases and revenue recognition, responses have been far from uniform, and cloture for uniform standard revision appears far down the horizon. Revising revenue recognition considerations is part of a series of joint projects undertaken by the FASB and the IASB, consistent with the direction of convergence agreed upon by both Boards. Under convergence, any major proposed standard is mutually exposed, inciting comments from a global audience. Construction contractors, an industry filled with firms of various sizes, and in entrepreneurial nations, consisting of a large number of players, the formal accounting focus on revenue recognition, using percentage-of-completion accounting, carries an income statement emphasis. The proposed standard would impact all entities with contracts with outside customers, whether the entity is public, private or a non-profit organization (Lindberg, 2010). The proposed standard would have an entity recognize revenue based on satisfying a contract obligation based on changes in the balance sheet, where revenue is deferred until obligations are satisfied.

PROPOSED STANDARD BY THE BOARDS

With respect to the FASB Codification, the proposed standard would supersede most of the guidance currently provided in the Accounting Standards Codification, Topic 605. The standard affects any entity entering into contracts to provide goods or services which are central to the entity's ordinary activities. Goods or services include the construction or development of an asset on behalf of a customer. The standard would alter the traditional procedures of percentage-of-completion accounting by calling for a series of steps in recognizing revenue. First, the contract or contracts with each customer must be clearly identified. Second, performance obligations in each contract must be separately identified. Third, the transaction price must be determined on a basis with consideration given to both cash and non-cash effects. Fourth, once the transaction price is determined, that price must be allocated to the separate performance obligations. Finally, revenue is recognized when the entity satisfies each performance obligation.

COST AND MANAGERIAL ISSUES

When do costs attach? Immediate expensing is required under the proposed standard for the costs of obtaining contracts. Capitalization is required if costs incurred in contract fulfillment are related to directly to the contract, generate or enhance resources of the entity which would be used in satisfying future performance obligations, and are fully anticipated to be recovered. The gross profit recognition is dependent upon select revenue and costs timing. Purists point to revenue recognition under U.S. GAAP as the culmination of an earnings process as described in Concepts Statement No. 5 of the FASB. And some authorities envision problems because the notion of an earnings process is "insufficiently precise" (Schipper, 2000). With specialized industries such as those involving long-term contracts, the percentage-of-completion method satisfied the need of many for appropriate and timely cost attachment, and hence, revenue recognition.

WORKING PRACTICE FOR CONSTRUCTION CONTRACTORS

The proposed standard if implemented would represent a major departure from the vanguard SOP 81-1, Accounting for Performance of Construction-Type and Certain Production Type Contracts. (AICPA, 1981). As currently written, the proposed standard misses the mark of delivering any enhancements in financial accounting and reporting. Furthermore, the costs associated with the revenue recognition procedures being proposed greatly exceed any benefits for preparers, users, external accountants, and other parties. These concerns fall into three major categories: theory of good, appropriate accounting, the practice of good, appropriate accounting, and the dangers associated with universal adoption ignoring preparer and user needs. Accordingly, experience with traditional revenue recognition from both the theoretical and practical side point to a highly successful mechanism for financial accounting and reporting, and efforts to make "one size fit all" will not be expedient.

IMPROVEMENTS IN THEORY?

Accrual accounting is not always generally accepted (GAAP). Construction contractors in the U.S. have been operating well for over half a century under the authoritative guidance found in the Accounting Research Bulletin on preference for percentage-of-completion accounting, and the more detailed procedures and guidance found in the Statement of Position and related Accounting and Audit Guide for contractors. Under those standards, management provides information in the financial statements which addresses all the key issues of financial reporting, including the concepts of timing of revenue realization, as well as cost or expense matching. It is not clear that changes described in the exposure draft would in any way improve the conceptual underpinnings, or lead to information any more useful for the informed decision-makers in the industry group.

IMPROVEMENTS IN PRACTICE?

Not only could distortions result from internal management reporting, but a severe effect would be felt on decisions made by external financial statement users. Banks and sureties rely on information generated from the percentage-of-completion financial statements. Job schedules are frequently keys to making informed decisions by bonding agents who subscribe to benefits derived from percentage-of-completion accounting. Those schedules are based on competitive overhead and include the best estimates of costs and tracking methods that are reasonably feasible. The spread between accrual and percentage-of-completion accounting is reconciled through the asset, underbillings, and the liability, overbillings. Over and under billed amounts would be distorted if components of jobs were arbitrarily decomposed. Financial institutions demand clear-cut information for compliance on working capital metrics. By shifting the income statement emphasis realized under percentage-of-completion to the balance sheet emphasis of performance obligations and liabilities, historical benchmarks of working capital become skewed. Covenants and other agreements based upon the prior sound accounting infrastructure would carry less meaning.

WHAT SHOULD BE THE FOCUS?

Allocation and timing issues continue to be areas hotly contested. Researchers comparing US GAAP with IFRS find that the most significant differences in revenue recognition concerns the issues of those contracts which are long-term and upon which payments are deferred until future periods (Bohusova, 2009).

The Boards' deliberations on issues outside of revenue recognition are not always consistent, which may well be appropriate in what is needed for smaller entities is a flexible focus. While some recently issued standards have addressed general needs and have been packaged in such a way as to not impede economic progress and yet improve financial reporting (for example, the "Subsequent Events" standard), one size, or one methodology, does not fit all prepares and users. Small and mid-size construction contractors in the United States of America operate in an environment far different from both large contractors in this country, as well as firms of various sizes internationally. While the FASB in partnering with other standard setters and advisory groups, and in forming the Blue Ribbon Panel to evaluate critical issues for private company reporting should be applauded, the current efforts on global standard setting and complete convergence with international standards works at cross purposes.

Guidance currently found under percentage-of-completion accounting works well in the overall management of the process—from bidding on jobs through completion and reporting. This has been a time-tested method that delivers results of truly satisfying the needs of fulfillment on "performance obligations." Any perceived broken pieces to a revenue recognition puzzle should be properly assessed and evaluated, prior to setting a global standard which fails to deliver meaningful results.

IMPACT ON THE SMALL BUSINESS OWNER

Arbitrarily splitting or segmenting jobs on construction contracts is far from desirable. Performance obligation levels provide complexities and produce the additional risk of having a measurement system which unnecessarily generates less consistency and transparency. Subjectivity breeds manipulation. Any given construction project may have highly interrelated risks which cannot be easily decomposed. When such risks are inseparable an entity does not have the basis assumed in the proposed standard to designate what components of a contract it could sell separately. In reality, for many of the jobs bid by the smaller contractors there is only a single performance obligation.

Comment Letters submitted to the FASB reveal that surety companies are very reluctant to embrace the changes that would be imposed. There is a sense of general satisfaction with the current process, using strong cost estimates, by professionals, to produce traditional revenue recognition amounts per contract. Overhead allocations will become even further complex. Statement of Position 81-1 has worked well for years, is widely accepted by both the surety and the banking industry, and leads to accurate, objective and useful revenue recognition for construction contractors. The small construction contractor incurs significant costs in obtaining skills for bidding estimates. The Boards appear to not appreciate that additional costs would be incurred, and such would be not easily absorbed by these smaller entities.

COSTS RELATED TO OTHER PARTIES

The realities of commerce and the association of various parties in the delivery of relevant information should be considered. The work of external CPAs and their accounting and auditing practices rendering assurance services on the financial statements would likely be accompanied by fee increases. Compliance with statutory requirements, such as Internal Revenue Service, will bring forth additional costs in reconciling book to tax temporary differences. Benchmarking as a whole and materiality measurements will be skewed as new, complicated accounting methodology is applied. Performance obligations are not the measurements sought or needed by any of these parties.

RECOMMENDATIONS

Should revenue recognition accounting be changed for construction contractors? The AICPA's Financial Reporting Executive Committee concluded in December, 2010 that the standard "May be neither practical nor operational for preparers and auditors to apply without undue cost." (Lamoreaux, 2011). The impracticality was also identified by the American Accounting Association's Financial Accounting Standards Committee (AAA FASC), using a recognition prior to title transfer (Colson, 2010). With both the AICPA and AAA expressing concern about the suitability of the proposed standard for construction contractors, it is not surprising that the standard is not expected to be quickly finalized.

Should financial accounting rules be changed that in no great way do anything to enhance the managerial accounting and specific needs of the construction contractor and other parties? The Boards need not rush to cloture on setting binding financial accounting rules in those areas that does not need fixing. The current financial reporting model for construction contractors may not be perfect, but the Boards have not provided a proposed standard that improves satisfying user needs, but only one that increases costs to the various parties. With an astounding 972 formal letters of comment submitted, the Boards have their hands full. While the comments appear to run generally in favor of the status quo, the Boards' dissection and analysis of the various views are likely to take time. The initial target of July, 2012 for a new sweeping pronouncement appears to be more unlikely with the passage of time. Adoption of a revised revenue recognition standard to apply to the small U.S. construction contractor is still safe—but for how long?

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