

Revenue Recognition: **COMBINING CONTRACTS** SPECIFIC GUIDELINES AND EXAMPLES

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Under Accounting Standards Codification section 606, Revenue from Contracts with Customers (“ASC 606”), one of the more potentially significant points of analysis and impact for contractors relates to whether certain contracts should be combined from an accounting perspective. The new standard contains specific guidance for analyzing whether combining should occur. Importantly, and different from the potential result under previous revenue recognition guidance, combining is not optional under ASC 606. Based on the facts and circumstances of the particular contract/contracts, if ASC 606 combining conditions are met, combining must occur. If contracts must be combined, then only a single contract asset or contract liability is reported for the combined contract, and any potential loss contract is recognized only if a loss would result on the combined contract.

The best way to highlight the ASC 606 guidance related to this subject is to present examples and fact patterns to show how determinations and judgments can be applied to these situations. Prior to going into the examples, the specific guidance related to combining is as follows, taken directly from the text of ASC 606 from the Financial Accounting Standards Board:

COMBINING CONTRACTS

ASC 606-10-25-9:

“An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

- a. **The contracts are negotiated as a package with a single commercial objective.**
- b. **The amount of consideration to be paid in one contract depends on the price or performance of the other contract.**
- c. **The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.”**

IDENTIFYING PERFORMANCE OBLIGATIONS

606-10-25-14:

At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:

- a. A good or service (or a bundle of goods or services) that is distinct
- b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (see paragraph 606-10-25-15).

606-10-25-15:

A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.
- b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

606-10-25-16:

A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer also may include promises that are implied by an entity's customary business practices, published policies, or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.

606-10-25-17:

Performance obligations do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

606-10-25-18:

Depending on the contract, promised goods or services may include, but are not limited to, the following:

- a. Sale of goods produced by an entity (for example, inventory of a manufacturer)
- b. Resale of goods purchased by an entity (for example, merchandise of a retailer)
- c. Resale of rights to goods or services purchased by an entity (for example, a ticket resold by an entity acting as a principal, as described in paragraphs 606-10-55-36 through 55-40)
- d. Performing a contractually agreed-upon task (or tasks) for a customer
- e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides
- f. Providing a service of arranging for another party to transfer goods or services to a customer (for example, acting as an agent of another party, as described in paragraphs 606-10-55-36 through 55-40)

- g. Granting rights to goods or services to be provided in the future that a customer can resell or provide to its customer (for example, an entity selling a product to a retailer promises to transfer an additional good or service to an individual who purchases the product from the retailer)
- h. Constructing, manufacturing, or developing an asset on behalf of a customer
- i. Granting licenses (see paragraphs 606-10-55-54 through 55-65)
- j. Granting options to purchase additional goods or services (when those options provide a customer with a material right, as described in paragraphs 606-10-55-41 through 55-45).

606-10-25-19:

A good or service that is promised to a customer is distinct if both of the following criteria are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- a. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

606-10-25-20:

A customer can benefit from a good or service in accordance with paragraph 606-10-25-19(a) if the good or service could be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

606-10-25-21:

Factors that indicate that an entity's promise to transfer a good or service to a customer is separately identifiable (in accordance with paragraph 606-10-25-19(b)) include, but are not limited to, the following:

- a. The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract into a bundle of goods or services that represent the combined output for which the customer has contracted. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer.

- b. The good or service does not significantly modify or customize another good or service promised in the contract.
- c. The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services in the contract might indicate that the good or service is not highly dependent on, or highly interrelated with, those other promised goods or services.

606-10-25-22:

If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.



EXAMPLES

GENERAL CONTRACTOR EXAMPLE

A general contractor (the “Contractor”) has won two contracts related to the construction of a multi-use development that will be accomplished in three phases (the “Development”). The contracts were bid concurrently with the same customer.

Under the first contract, the Contractor will complete Phase 1 which includes clearing, grading, and installation of basic infrastructure over the entire Development site that will serve as the foundation for the remaining two phases. Phase 1 is to be completed in Year 1 of the project. The first contract also includes Phase 2 which calls for all remaining elements of constructing an open-air mall consisting of four two-story buildings of retail space surrounded by parking lots, to be completed in Year 2. The second contract is for Phase 3 and includes the build-out of residential condominiums and office space on the second floor of the buildings constructed in Phase 2 and is expected to be completed in Year 3. Phase 1 and 2 are to start immediately upon contract award, with Phase 3 to be started subsequent to the completion of Phase 2.

The first step in the application of ASC 606 is identifying the contract. Specific to this example, the Contractor would need to consider ASC 606-10-25 and ultimately decide if the two contracts entered into should be combined. According to ASC 606-10-25-9 “An entity shall combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one of more of the following criteria are met:

- a. The contracts are negotiated as a package with a single commercial objective.
- b. The amount of consideration to be paid in one contact depends on the price or performance of the other contract.

- c. The goods or services promised in the contracts (or some of the goods or services promised in each of the contracts) are a single performance obligation in accordance with paragraphs 606-10-25-14 through 25-22.”

In our case the contracts were entered into at the same time and with the same customer, so now we must evaluate the three criteria and if any one of them is met, combine the contracts. Let’s assume the contracts were not negotiated as a package and were bid competitively or negotiated independently, so “a” does not apply. As with many aspects of ASC 606, this step requires significant judgement in determining its applicability. Also, assuming the contracts were priced by the Contractor using standalone prices (i.e. the price of one contract was in no way affected by the price of another), “b.” also does not apply. Similarly, if the ability to perform for a given price on the second contract was not favorably influenced by some other facet of the first contract (i.e. excess materials from the first contract not being usable on the second contract, so does not assist with pricing and performance on the second contract), “b. would not apply. Examining whether the promises in the contracts constitute a single or multiple performance obligations, as required by criteria “c.” brings us to Step 2 – Identifying Performance Obligations.

In applying Step 2 of ASC 606, the Contractor must first identify all promises contained in the contracts. By signing these contracts, the Contractor is obligated to deliver finished facilities including multiple buildings as well as ancillary constructed items such as parking lots and sidewalks. You could even argue the promises should be broken down even further into retail units, offices, residential, etc. The concept of “distinct” is the key factor when identifying promises under ASC 606. ASC 606-25-19 defines promises as distinct “if both the of the following criteria are met:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct”.
- a. The entity’s promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

The customer could certainly derive economic benefit from each of these separate promises making them capable of being distinct. It is important to view the scenario through the eyes of the customer, and, if the contracts as a whole are seen as a single objective, they should be combined. However, significant judgement is required on the part of the Contractor to determine if these promises are also distinct within the context of the contract. As described, the performance of these contracts will result in a single-site development owned by the same customer. While each element of construction is capable of being distinct, all retail units, condominiums, offices, and ancillary components are highly interrelated as they are all part of the larger development undertaken by the contract. The concept of interdependence or interrelation is one of the qualifying factors considered per AC 606-10-25-21 in assessing whether promises are separately identifiable. Considering this, it is likely the promises listed above are not distinct within the context of the contract when looking at the promises through the eyes of the customer, not the Contractor and its contractual commitments. The Development should be considered one performance obligation. As such the Contractor would combine the contracts into a single unit of account.

When applying these concepts and evaluating whether contracts should be combined, the facts and circumstances of each contract(s) must be thoroughly evaluated in great detail. To highlight this fact, let's take the same fact pattern with the following adaptations:

- a. The second contract for Phase 3 is entered into with a different unrelated customer.
- b. The second contract for Phase 3 was entered into during Year 2 after completing Phase 1 but prior to completing Phase 2.
- c. Phase 3 calls for the construction of a movie theatre adjacent to the Development that is determined to be distinct from the other promises (a separate performance obligation).

If any of these three changes to the fact pattern were true, the result would likely be that the contracts would not be combined and would retain their contract identity as two separate units of account. Note that there is no bright-line guidance on what period of time is intended by the condition "at or near the same time" in the context of negotiating a contract. This determination will require judgment but should be consistently applied.

DESIGN / BUILD EXAMPLE

A private company is building a new office building and has requested separate bids for the initial design of the project, construction, and on-going guaranteed preventative maintenance. A contractor who specializes in design build projects purposely enters a loss leader bid to win the design contract because they believe the owner will most likely select the winning designer to complete the remaining construction and maintenance contracts. Once construction is completed, the contract requires the contractor to perform maintenance as necessary for a period of five years that covers virtually all elements of the building to operate and function as intended including equipment failure and normal wear and tear. The owner will issue a contract for the design services and a second contract for the construct/maintain services.

In determining whether these contracts should be combined, the contractor must first identify the contract. Using the guidance noted above from ASC 606-10-25, the contracts should be combined as they are both negotiated as a package with a single commercial objective and the consideration paid under the construction and warranty phases is dependent on winning the design phase under the loss leader pricing.

Let's change one fact from the previous example for our consideration of combining the contracts. In this case, rather than the warranty contract being bid as a separate contract, the customer requested a change order to the construction contract to include the warranty work. The contractor must determine if the contract modification is a separate contract or if it should be included as a change order to the construction contract.

Per ASC 606-10-25-12:

An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

The warranty work would likely be considered to be a promise that is both capable of being distinct and distinct within the context of the contract. Additionally, it is unlikely that the contractor would price this scope of work at a discount. Therefore, the change order should be segmented and accounted for as a separate contract. Extended warranty and maintenance provisions typically will represent a separate performance obligation.

TRADE CONTRACTOR EXAMPLE

Single location with separate pricing for different phases of project

A plumbing contractor enters into contracts to design and install the plumbing system at a new single office building. The plumbing contractor is responsible for designing the system, purchasing the material, and self-performing or subcontracting out the installation of the system. The plumbing contractor enters into separate contracts for the preconstruction/design work and the installation of the system.

The design and installation contracts should be analyzed to determine if the separate contracts should be combined.

The contracts are negotiated together with a single commercial objective (the plumbing contractor completing a plumbing system as a product of the agreements for a certain combined margin). The plumbing installation is highly dependent on and interrelated with the design services.

Assuming these facts and circumstances, the design and installation of the system contracts should be combined into a single contract for accounting purposes. It should be noted that these facts and circumstances would also most likely result in a single performance obligation under the contract as well, since the prime contractor is really contracting for the delivery of a completed/installed plumbing system in the building. While the separate contracts are performance obligations which are capable of being distinct, they are not separately identifiable promises from the customer's perspective (in other words, distinct in the context of the contract with the prime contractor). See ASC 606-10-25-21, which discusses in greater detail the considerations for determining if a transfer of goods/services to a customer are separately identifiable promises.

TRADE CONTRACTOR EXAMPLE

Multiple locations/contracts under one master contract

As a modification of the example above, let's say that the owner of the office building is having three separate buildings constructed in the same complex over the next four years, and the owner is using the same prime contractor for all three buildings. The next building will be started around the time the previous building is completed.

The prime contractor would like to contract the same plumbing subcontractor for all three buildings, so there will be a Master Contract showing general terms and conditions covering the entire office complex, along with a total estimated contract value of the office complex plumbing work. This master contract will not have pricing details and detailed specifications related to each building, and the estimated Master Contract value is subject to specific bidding for each building to be approved in the future by the prime contractor prior to commencement of construction of each building. The detailed specifications and work to be completed for each building will have a separate contract, which will be negotiated/agreed to at the onset of each building project.

The plumbing contractor will not perform detailed design work until notified by the prime contractor to proceed for each building project, and the pricing for the design/installation of the system for each building will be determined at that time for each of the three buildings. Moreover, the timing of work for each building will likely be separated by roughly nine to twelve months, so the plumbing subcontractor crews will not be continuously onsite over the course of the complex build out.

We must first determine if the Master Contract is a contract under ASC 606-10-25-1, which stipulates five criteria which must be met to have a contract:

- The parties have approved the contract and are committed to perform their respective obligations
- Each party's rights are identified
- Payment terms are identified
- The contract has commercial substance
- It is probable that substantially all of the consideration will be collected

Since the Master Contract does not formally commit the plumbing contractor and the prime contractor to their respective obligations (i.e. the detailed responsibilities, specifications and pricing details are not known until each individual building contract is executed), the Master Contract does not qualify as a contract under ASC 606. The separate contracts for each building plumbing system underneath the Master Contract terms and conditions would reasonably be separate contracts from an accounting perspective.

Conclusion

The above examples are just that, examples. Throughout ASC 606, the words "facts and circumstances" are mentioned, as the standard does not want to set bright lines in the analysis. ASC 606 requires a high degree of professional judgment of the specific circumstances of a contract to determine proper revenue recognition. The decision to combine contracts is just one of many judgments and determinations which must be made to properly account for revenue within the context of ASC 606.

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