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GOVERNMENT CONTRACTORS-REVENUE RECOGNITION IMPACTS

An Overview of the 5-Step Revenue Recognition Framework and Targeted Impacts to Government Contractors

Executive Summary

- Non-public government contractors with fiscal years beginning after December 15, 2018 will adopt the provisions of FASB ASU 2014-09, Revenue from Contracts with Customers (ASU 2014-09) during 2019.
- ASU 2014-09 is a substantial overhaul of the existing revenue recognition standards and emphasizes evaluating performance obligations in a contract with a customer and when control of those performance obligations transfers to customers.
- ASU 2014-09 also adds variability into the transaction price in a contract with a customer which had previously required recognition deferral.
- While ASU 2014-09 is a principles based approach to revenue recognition that seeks to reduce the volume of industry specific revenue recognition guidance, there are a few industry specific considerations for government contractors that need to be evaluated including:
  - Regulatory approval
  - Unfunded government contracts
  - Blanket purchase orders
  - Termination for convenience and substantive disincentives for non-performance
  - Variable consideration
  - Alternative use and enforceable right to payment
  - Synthetic FOB destination

5-Step Revenue Recognition Framework Overview

In order to contextualize government contractor industry specific matters in this article, a summary of the 5 step revenue recognition framework is presented below.

STEP 1 – IDENTIFY THE CONTRACT(S) WITH A CUSTOMER

A contract is an agreement between two or more parties that creates enforceable rights and obligations[1]. Enforceability of the rights and obligations in a contract is a matter of law. Contracts can be written, oral or implied by a government contractor's customary business practices. A government contractor should account for a contract with a customer that is within the scope of FASB ASC 606 when all of the following criteria are met[2]: it has the approval and commitment of the parties; rights of the parties are identified; payment terms are identified; the contract has commercial substance; and collectability of substantially all of the consideration is probable.

A contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party[3].

Combining Contracts

A government contractor should combine two or more contracts entered into at or near the same time with the same customer and account for the contracts as a single contract if one or more of the following criteria are met[4]: the contracts are negotiated as a package with a single commercial objective; the amount of consideration to be paid in one contract depends on the price or performance of the other contract; or the goods or services promised in the contracts are a single performance obligation.

Contract Modifications

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties of the contract.[5] A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price.[6] The accounting for contract modifications depends on whether the additional goods or services are distinct, and whether the price for the additional distinct goods or services represents a standalone selling price.

STEP 2—IDENTIFY THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

FASB ASC 606 identifies the unit of account at the performance obligation level. A government contractor should assess the goods or services promised in a contract with a customer at contract inception. Each promise to transfer one of the following to the customer is considered a performance obligation[7]: a good or service (or bundle of goods or services) that is distinct; or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

A good or service that is promised to a customer is distinct if both of the following criteria are met[8]: it is capable of being distinct meaning that the customer can benefit from a good or service either on its own or together with other resources that are readily available to the customer; and it is distinct within the context of the contract meaning that the government contractor's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.

STEP 3—DETERMINE THE TRANSACTION PRICE

The transaction price is the amount of consideration to which a government contractor expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.[9] When determining the transaction price, a government contractor should consider the effects of the following[10]: variable consideration; constraining estimates of variable consideration; the existence of a significant financing component; noncash considerations; and consideration payable to the customer.

If the consideration promised in a contract includes a variable amount, a government contractor shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.[11] An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, volume incentives, performance bonuses, penalties or other similar items. The promised consideration also can vary if a government contractor's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event.[12]

A government contractor needs to consider the FASB's constraining estimates of variable consideration, which means that a government contractor should include in the transaction price some or all of an amount of variable consideration only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.[13]

STEP 4—ALLOCATE THE TRANSACTION PRICE TO THE PERFORMANCE OBLIGATIONS IN THE CONTRACT

The objective when allocating the transaction price is for a government contractor to allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the government contractor expects to be entitled in exchange for transferring the promised goods or services to the customer.[14]

A government contractor should generally allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis.[15]

The standalone selling price is the price at which a government contractor would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the government contractor sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be the standalone selling price of that good or service.[16]

If a standalone selling price is not directly observable, a government contractor needs to estimate the standalone selling price. When estimating a standalone selling price, a government contractor should consider all information, including market conditions, entity-specific factors and information about the customer or class of customer, that is reasonably available to the government contractor. In doing so, a government contractor should maximize the use of observable inputs and apply estimation methods consistently in similar circumstances.[17]

STEP 5—RECOGNIZE REVENUE WHEN (OR AS) THE ENTITY SATISFIES A PERFORMANCE OBLIGATION

A government contractor should recognize revenue when, or as, the entity satisfies a performance obligation by transferring a promised good or service to a customer. An asset is transferred when, or as, the customer obtains control of that asset.[18]

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset.[19]

For each performance obligation identified, an entity should determine at contract inception whether it satisfies the performance obligation over time or at a point in time.

A government contractor transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met[20]: the customer simultaneously receives and consumes the benefits provided by the government contractor's performance as the government contractor performs; the government contractor's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or the government contractor's performance does not create an asset with an alternative use to the entity and the government contractor has an enforceable right to payment for performance completed to date.

If a government contractor does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A government contractor needs to consider indicators of the transfer of control to determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation. These include, but are not limited, to the following examples[21]: the government contractor has a present right to payment for the asset; the customer has legal title to the asset; the government contractor has transferred physical possession of the asset; the customer has the significant risks and rewards of ownership of the asset; or the customer has accepted the asset.

REGULATORY APPROVAL (STEP 1 ISSUE)

Government contractors often do business with foreign government entities, requiring approval from the U.S federal government. The two most common forms of foreign contracting are foreign military sales (FMS) and foreign direct commercial sales (DCS). There are generally no regulatory hurdles in a FMS model, because the U.S. federal government is responsible for ensuring that all necessary regulatory approvals are in place prior to contract inception. In a DCS model, the government contractor directly contracts with the foreign entity and subsequently obtains U.S. federal government approval. Physical delivery of the goods to the foreign entity is prohibited until all necessary approvals are obtained, however the government contractor is permitted to manufacture the goods promised in the contract. The U.S federal government reserves the right to block physical delivery even after all regulatory approvals have been received.[22]

DSC contracts pose potential issues from a Step 1 standpoint, because it is uncertain whether or not regulatory approvals will be obtained. This likelihood should be assessed based upon a government contractor's history of receiving regulatory approval, whether the government contractor has been proactive in communicating its intentions with the U.S. federal government, the political climate surrounding the foreign customer and the project; and results of recent regulatory approvals to the same country.[23] The uncertainty in obtaining government approvals does not necessary preclude the existence of a DCS contract under the five criteria in Step 1 of the revenue recognition framework.

UNFUNDED GOVERNMENT CONTRACTS (STEP 1 AND STEP 3 ISSUE)

Long term contracts with the U.S federal government may only be partially funded. If a government contractor has determined that it has met the five criteria required in Step 1 for a contract with a customer to exist and the contract is either partially or completely unfunded by the government, the contractor should analyze the unfunded portion of the contract under Step 3 of the revenue recognition framework. The unfunded portion of the contract is analyzed as variable consideration subject to certain constraints. In the AICPA Audit and Accounting Guide – Revenue Recognition, the AIPCA Aerospace and Defense Revenue Recognition Working Group includes a list of appropriate measures that government contractors should consider in constraining its estimates of variable consideration for unfunded contracts including[24]: whether there is a short period of time before contract funding is expected; whether the work is sole source, a follow-on effort, or there is high competition; whether the funding and budgeting exists and the task of processing the funding is administrative only; whether it is a major program or the customer is in critical need of the program; whether there has been communication from the customer and or the government that funding will be obtained; and whether the entity has a history of receiving funding in similar situations.

BLANKET PURCHASE ORDERS (STEP 1 ISSUE)

Government contractors that enter into blanket purchase order agreements may need to consider combining contracts under Step 1 of the revenue recognition framework. Blanket purchase orders establish pricing or pricing mechanisms under which all subsequent order releases for quantities are governed. If the amount of consideration to be paid in one contract depends on the price or performance of the other contract, then the contracts should be combined. If a blanket purchase order establishes a common pricing or there is a cumulative volume discount, government contractors may need to consider whether or not the contracts need to be combined.

TERMINATION FOR CONVENIENCE AND SUBSTANTIVE DISINCENTIVES FOR NON-PERFORMANCE (STEP 1 AND STEP 5 ISSUE)

Termination clauses can impact a government contractor's evaluation of the duration of the contract term. Under most circumstances, the legally enforceable contract period dictates the contract period for accounting purposes. However, if termination penalties are not substantive disincentives for non-performance, then the government contractors may conclude that the contract term is less than the legally enforceable contract period. Conversely, if termination penalties are substantive disincentives for non-performance, the legally enforceable contract period likely prevails.

Many contracts with the U.S. federal government contain termination for convenience clauses where the U.S. federal government may terminate the contract in the interest of the government. The termination rights held by the U.S federal government are governed by Federal Acquisition Regulations (FAR) – Additional Principles for Fixed-Price Contracts Terminated for Convenience. FAR 29.201(a) requires that if termination for convenience rights are exercised, "a settlement should compensate the contractor fairly for the work done and the preparations made for the terminated portions of the contract, including a reasonable allowance for profit."

VARIABLE CONSIDERATION (STEP 3 ISSUE)

The most common types of variable consideration that government contractors encounter include[25]: award fees, claims, cost incentives or penalties, economic price adjustments, billing rate adjustments, performance incentives or penalties, price adjustment or redetermination clauses and unpriced contract modifications. All forms of variable consideration need to be estimated at contract inception and included in the determination of the transaction price. The estimate of variable consideration is then subject to the constraint that there will not be a significant reversal of cumulative revenue recognized once the variability is resolved.

ALTERNATIVE USE AND ENFORCEABLE RIGHT TO PAYMENT (STEP 5 ISSUE)

The new revenue recognition standard shifts the focus from the transfer of risk and rewards of ownership under legacy revenue recognition to the transfer of control of the performance obligations in a contract. In analyzing the three criteria for over time revenue recognition, special attention should be given to the third criterion, the government contractor's performance does not create an asset with an alternative use to the contractor and the contractor has an enforceable right to payment for performance completed to date.

Alternative Use

FASB ASC 606-10-25-28 states that "an asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use or limited practically from readily directing the asset in its completed state for another use." When an asset has no alternative use, the customer obtains control as it is created. Conversely, when there is an alternative use, the asset can be substituted for other customer orders.[26]

FASB ASC 606-55-10 states that "a practical limitation on an entity's ability to direct an asset for another use exists if an entity would incur significant economic losses to direct the asset for another use." Any contractual restrictions on the alternative use of assets need to be substantive in order to conclude that the assets have no alternative use.[27]

Enforceable Right to Payment

A government contractor will have an enforceable right to payment if the contract is terminated by the customer for convenience and the contractor will be compensated for the performance completed to date. The compensation needs to include a reasonable profit margin and not solely cost reimbursement for work in progress. In order to determine whether an enforceable right to payment exists, a legal determination may be required as well as an analysis of the customary business practices.

SYNTHETIC FOB DESTINATION (STEP 2, STEP 4 AND STEP 5 ISSUE)

If a government contractor has concluded that it does not satisfy a performance obligation over time, the performance obligation is satisfied at a point in time. A contractor would then examine indicators of the transfer of control. If a contractor determines that the transfer of legal title based upon the shipping terms is the best indicator of the transfer of control, an awareness of a significant change from legacy revenue recognition practices is crucial. From time to time, government contractors may ship goods FOB shipping point and also promise to replace any goods that are lost or damaged during shipment. Under legacy revenue recognition, the risks and rewards had not entirely transferred even though title had transferred to the customer upon delivery to the common carrier, thereby necessitating a deferral of the revenue until the goods were delivered. This situation created a synthetic FOB destination arrangement. Under the new revenue recognition standards, the transfer of control of the performance obligation to deliver the goods has occurred upon the delivery to the common carrier. A separate performance obligation is required for the in-transit protection against lost or damaged goods. The transaction price determined in Step 3 of the revenue recognition framework would be allocated between these two performance obligations. This would accelerate revenue recognition compared to the legacy requirements.

Endnotes

[1] FASB ASC 606-10-25-2
[2] FASB ASC 606-10-25-1
[3] FASB ASC 606-10-25-4
[4] FASB ASC 606-10-25-9
[5] FASB ASC 606-10-25-10
[6] FASB ASC 606-10-25-11
[7] FASB ASC 606-10-25-14
[8] FASB ASC 606-10-25-19
[9] FASB ASC 606-10-32-2
[10] FASB ASC 606-10-32-3
[11] FASB ASC 606-10-32-5
[12] FASB ASC 606-10-32-6
[13] FASB ASC 606-10-32-11
[14] FASB ASC 606-10-32-28
[15] FASB ASC 606-10-32-29
[16] FASB ASC 606-10-32-32
[17] FASB ASC 606-10-32-33
[18] FASB ASC 606-10-25-23
[19] FASB ASC 606-10-25-25
[20] FASB ASC 606-10-25-27
[21] FASB ASC 606-10-25-30
[22] *Audit and Accounting Guide - Revenue Recognition* - Chapter 3 Aerospace and Defense Entities. 2018th ed. Durham, NC: American Institute of Certified Public Accountants, 2018.
[23] ibid
[24] ibid
[25] *Audit and Accounting Guide - Revenue Recognition* - Chapter 3 Aerospace and Defense Entities. 2018th ed. Durham, NC: American Institute of Certified Public Accountants, 2018.
[26] ibid
[27] ibid

Our Thoughts On

These new rules will take effect for annual periods beginning after December 15, 2018 for non-public government contractors. The adoption of these new rules will take careful planning and could require changes throughout your entire organization, not just within accounting and finance. We have seen that public entities and other non-public adopters have needed a significant amount of time to get this new standard right.

Wherever you are in your implementation project, Schneider Downs has the resources and the experts you need to complete your project. We have led many successful implementation projects, and we understand what it takes to get the job done. No two implementation projects are the same, and our customized tools provide you with the flexibility to address your unique industry and organization needs. Our revenue recognition assessment is modeled after ASC 606's five-step framework and has been developed to help you quickly identify implementation issues. Our experts will craft a tailored project plan aimed at addressing areas of concern and achieving your objectives.

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Schneider Downs Accounting Advisory Services Contacts

Adam Goode
Audit, Senior Manager – Pittsburgh
agoode@schneiderdowns.com
412.697.5411

Nick Lombardo
Audit, Senior Manager – Columbus
nlombardo@schneiderdowns.com
614.586.7132