

Changes to revenue recognition for federal government contractors

Prepared by:

Mandy Wheat, Partner, RSM US LLP
mandy.wheat@rsmus.com, +1 703 336 6357

Julia K Amstutz, Senior Manager, RSM US LLP
julia.amstutz@rsmus.com, +1 309 497 12611

April 2019

TABLE OF CONTENTS

A. Introduction	1
B. Federal government contractor revenue recognition overview	2
C. Five-step revenue recognition model	2
C.1 Identify the contract with a customer	2
C.1.1 Contract existence criteria	2
C.1.2 Contract term and the impact of customer termination provisions	3
C.1.3 Combining contracts	4
C.1.4 Contract modifications	4
C.2 Identify the performance obligations in the contract	6
C.2.1 Identifying promises to transfer goods or services	7
C.2.2 Separating promises to transfer goods or services into performance obligations	7
C.2.2.1 Series of distinct goods or services	9
C.3 Determine the transaction price	9
C.3.1 General requirements	9
C.3.2 Variable consideration	9
C.3.2.1 Estimating variable consideration	10
C.3.2.2 Variable consideration constraint	11
C.3.2.3 Unfunded contracts	12
C.4 Allocate the transaction price to the performance obligations	14
C.5 Recognize revenue when (or as) each performance obligation is satisfied	15
C.5.1 Determine whether a performance obligation is satisfied over time or at a point in time	16
C.5.1.1 No alternative use	16
C.5.1.2 Enforceable right to payment	17
C.5.1.3 Recognizing revenue for performance obligations satisfied over time	18
C.5.1.3.1 Output methods	19
C.5.1.3.2 Input methods	20
C.5.2 Loss provisions	22
C.5.2.1 Recognition and measurement	24
C.5.2.2 Current estimate of contract costs	24

C.5.2.3 Current estimate of consideration expected to be received	24
C.5.2.4 Presentation of loss provision	24
D. Contract costs	25
D.1 Costs to fulfill a customer contract	25
D.2 Incremental costs to obtain a customer contract	25
D.3 Amortization and impairment of capitalized costs	26
E. Balance sheet presentation	26
E.1 Accounts receivable	26
E.2 Contract assets and liabilities	27
F. Disclosures	27
F.1 Disclosures required by ASC 606.....	27
F.1.1 Disaggregated revenue.....	27
F.1.2 Contract balances	28
F.1.3 Performance obligations	28
F.1.4 Transaction price allocated to remaining performance obligations	29
F.1.5 Significant judgments.....	29
F.1.6 Contract costs	30
G. Transition	30
H. Conclusion.....	31

The FASB material is copyrighted by the Financial Accounting Foundation, 401 Merritt 7, Norwalk, CT 06856, and is used with permission.

A. Introduction

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that spanned many years. The FASB's Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues, and upon its effective date, replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and SEC Staff Accounting Bulletin Topic 13 (which is also part of legacy GAAP for public entities).

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs) and certain not-for-profit entities (NFPs), implementation must occur no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either: (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies, which is annual reporting periods beginning after December 15, 2018, and interim periods thereafter.

The FASB amended the guidance included in ASU 2014-09 several times since its issuance. The new guidance primarily is included within the following sections of the FASB's Accounting Standards Codification (ASC):

- Topic 606, "Revenue from Contracts with Customers"
- Subtopic 340-40, "Other Assets and Deferred Costs – Contracts with Customers"

For a detailed discussion of the new guidance (as amended), refer to [A guide to revenue recognition](#). Additional information is available in our [Revenue Recognition Resource Center](#).

The American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces to identify and provide guidance on revenue recognition implementation issues in specific industries. The AICPA's ultimate objective was to develop a comprehensive nonauthoritative revenue recognition guide that provides helpful discussion and illustrative examples on how to apply the new guidance to contracts in various industries. The AICPA Audit and Accounting Guide, *Revenue Recognition* (the Revenue Recognition AAG), includes discussion of: (a) general accounting and auditing considerations related to the new guidance and (b) various industry-specific implementation issues. Additional information about the AICPA's industry-specific task forces and its Revenue Recognition AAG can be found on its [website](#).

Because federal government contracts can cross multiple industries, the AICPA did not create a single task force dedicated to federal government contractors. However, the Engineering and Construction Contractors and the Aerospace and Defense Revenue Recognition task forces did address certain issues common to federal government contracts, including the impact of termination for convenience clauses (see Section C.1.2) and the evaluation of the unfunded portion of a contract (see Section C.3.2.3).

RSM's white paper, [Changes to revenue recognition for construction contractors](#) provides additional industry specific insights that should be considered by federal government contractors entering into construction contracts.

B. Federal government contractor revenue recognition overview

The core principle underlying the guidance in ASC 606, which is included in ASC 606-10-10-2, is to “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.” The objective is met by applying a five-step process requiring the use of judgments, interpretation and estimates, as well as an understanding of significant contract terms. All contracts with customers fall within the scope of ASC 606 except for the following: (a) lease contracts, (b) contracts within the scope of ASC 944, “Financial Services – Insurance,” (c) various contractual rights or obligations related to financial instruments, (d) guarantees, except for product or service warranties and (e) certain nonmonetary exchanges. While the scope of ASC 606 is limited to revenue from contracts with customers, many aspects of the guidance in ASC 606 are also applicable to certain transfers of nonfinancial (and in substance nonfinancial) assets to counterparties other than customers.

Applying the new guidance to federal government contracts could significantly affect the timing and amount of revenue recognized for numerous reasons. For example, the guidance related to contingent revenue is being replaced with a new model for estimating and constraining variable consideration, which could affect the timing of when award fees, claims and other forms of variable consideration are recognized.

The accounting model applied to a federal government contract will differ under the new guidance. The new guidance introduces specific criteria to determine whether to recognize revenue over time or at a point in time. If revenue is recognized over time, a method of measuring progress toward completion will need to be selected, and it may no longer be appropriate to use the cost-to-cost method in certain facts and circumstances. The new accounting model for contract modifications, which include scope-related and price-related changes, could affect when the revenue related to a contract modification is recognized.

C. Five-step revenue recognition model

The new guidance includes the following five-step revenue recognition model:



For a comprehensive discussion of the five-step revenue recognition model and other aspects of the new guidance, refer to [A guide to revenue recognition](#).

C.1 Identify the contract with a customer

A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.” By definition, an agreement (whether written, oral or implied based on the entity’s usual business practices) must be enforceable for it to be considered a contract.

C.1.1 Contract existence criteria

The existence of a customer contract is not enough in and of itself to require application of the remaining steps in the ASC 606 revenue recognition model to the contract. Only if a customer contract meets the following contract existence criteria should it be accounted for in accordance with that model:

- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable
- Payment terms are identifiable
- Commercial substance exists
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur). This is commonly referred to as the collectibility criterion.

While in many cases, it will be relatively straightforward for a federal government contractor to determine whether a contract exists for accounting purposes, in some cases doing so may be more complex. For example, a federal government contractor may receive a notice to proceed verbally, or in an informal email, that may or may not meet the criteria to qualify as a contract.

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract. When all of the contract existence criteria are not met, revenue is deferred and the contract existence criteria continue to be evaluated to determine whether they are subsequently met. Absent meeting the contract existence criteria, revenue is only recognized under certain specific circumstances, which could result in the initial deferral of revenue for what may be a significant period of time, even if nonrefundable cash has been received. Additional discussion and examples related to Step 1 are provided in Chapter 5 of [A guide to revenue recognition](#).

C.1.2 Contract term and the impact of customer termination provisions

Determining the contract term is important because it will affect application of the remaining steps in the five-step revenue recognition model to the customer contract. For example, the contract term will affect the promised goods or services (and performance obligations) identified in Step 2 and the transaction price determined in Step 3.

The contract term is the period of time over which the entity and its customer have present enforceable rights and obligations. Determining this period may be affected by a number of factors, including whether the entity and (or) its customer have termination rights under the contract.

In discussions at the November 2015 FASB Transition Resource Group (TRG) meeting (*TRG Agenda Ref 49, November 2015 Meeting – Summary of Issues Discussed and Next Steps, paragraph 10*), TRG members highlighted that when performing an evaluation of the contract term and the effect of termination penalties, an entity should consider whether those penalties or other required payments are substantive. If so, the period subject to the substantive termination penalty should be included in the contract term. Otherwise, the period subject to the termination penalty should not be included in the contract term.

It is common for federal government contracts to give the customer a right to cancel for convenience without giving the federal government contractor a similar right. These “termination for convenience” clauses are meant to provide the government with the ability to suspend or terminate a project in the event unforeseen economic or political circumstances impact the project. Under such a termination clause, the federal government contractor is generally entitled to recover all costs incurred to the termination date, as well as an allowance for profit.

A federal government contractor’s history with terminations in various contract situations, together with its knowledge about the customer and the type of contract should be considered in assessing the termination penalty’s impact on a contract’s duration. The TRG’s discussion on cancellation rights, renewal options and substantive termination penalties is applicable to contracts in which a series of recurring goods and services are being provided. However, contracts for project design or construction are rarely terminated because there would be little value to a customer in a partially completed project, and potentially significant costs would be incurred to terminate a project. As a result, the contractor

should reflect its obligation to complete the entire project in its accounting treatment. Therefore, the term or duration of the contract should be as defined in the contract assuming no cancellation, until such time that the customer explicitly terminates the contract. In a contract to provide a recurring service over time, on the other hand, a requirement to pay for all previously provided services is not considered a substantive termination penalty as the customer has obtained all of the benefit from the prior service for which it is required to pay. Therefore, the contract would likely be accounted for on a month-to-month basis.

C.1.3 Combining contracts

If one or more of the following criteria are met, individual contracts with the same customer (or parties related to the customer) that are entered into at or near the same time should be combined for accounting purposes:

- The contracts were negotiated as a package and share the same commercial objective.
- The consideration to be paid under one contract is tied to the other contract's price or performance.
- Some or all of the goods or services in one contract and some or all of the goods or services in the other contract(s) represent a single performance obligation (i.e., some or all of the goods or services in each contract are not distinct from each other).

Federal government contractors should carefully consider the contract combination guidance when entering into a blanket purchase agreement (BPA) or an indefinite delivery/indefinite quantity (IDIQ) arrangement. Individual task orders under these arrangements may qualify for contract combination depending on the facts and circumstances. For example, orders under an IDIQ contract may need to be combined if the pricing of the goods or services in one order is tied to the pricing in another order (e.g., a cumulative volume discount). On the other hand, if each order is an optional purchase at standalone selling price, the orders are unlikely to require combination.

The requirement to combine contracts in certain situations for purposes of identifying a contract has no effect on an entity's requirement to separate promises to transfer goods or services into performance obligations. If a promised good or service within a combined contract meets the criteria for being distinct, it should be accounted for separately as a performance obligation.

This new guidance differs from legacy GAAP in which the ability to combine contracts was generally optional.

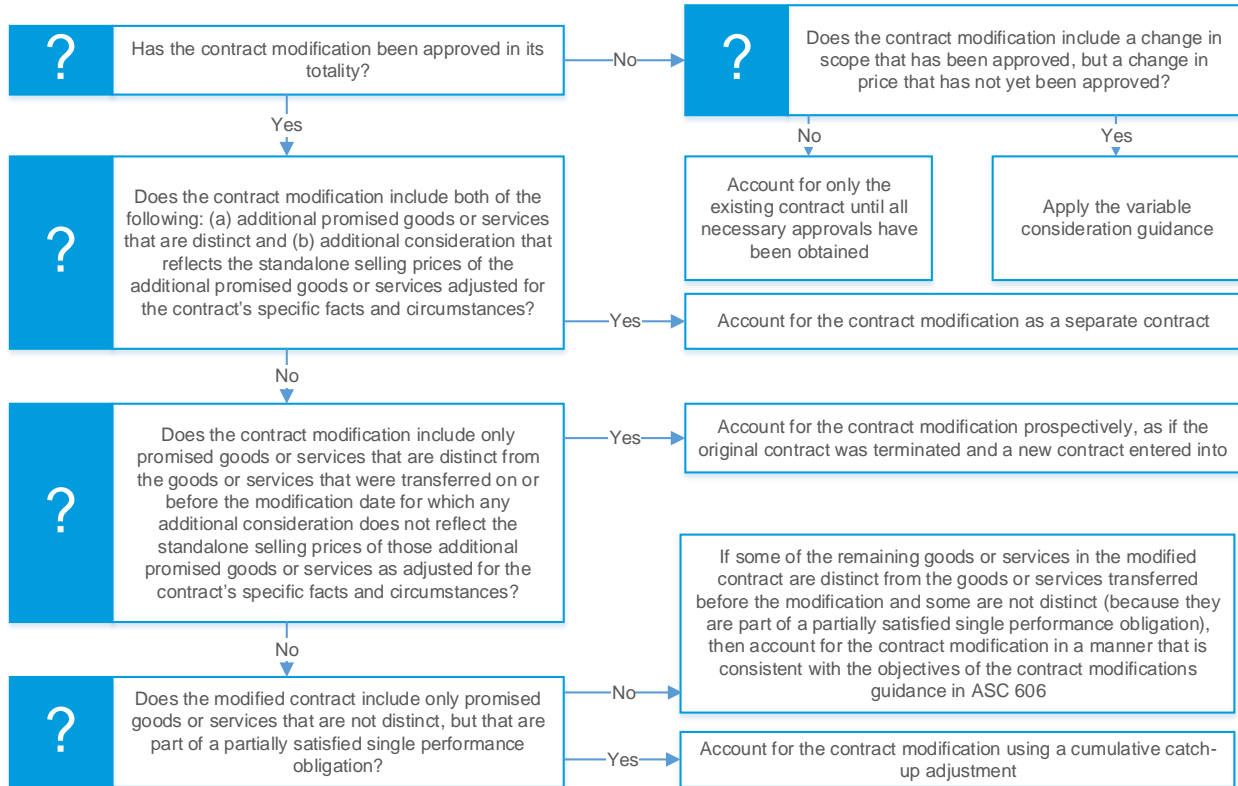
C.1.4 Contract modifications

Contract modifications occur when the entity and its customer agree to add or change enforceable rights and obligations in the contract (e.g., changes to the contract's scope and [or] price). The decision to add or change the contract's enforceable rights and obligations may be a normal part of the federal government contractor's relationship with its customer (e.g., modifications), or the decision may result from a dispute between the parties (e.g., resulting in claims or a request for equitable adjustment). While in some cases it will be clear that the enforceable rights and obligations in the contract have been changed and agreed to by the federal government contractor and its customer, in other cases it may not be so clear. In those cases where it is not clear, the entity should ensure it has considered all relevant facts and circumstances (including its customary business practices) and then carefully exercise judgment to determine whether the rights and obligations in the contract have changed and whether those changes are enforceable (which may require consultation with legal experts). Understanding whether the changes are enforceable is important because changes that are not enforceable do not give rise to changes in the accounting for the contract.

A contract modification may exist even though the parties to the contract have a dispute about the modification's scope or price (or both). Modifications in federal government contracts result from a variety of provisions, including modifying the term to extend the period of performance, providing additional

funding, or expanding the scope of work to be provided. The accounting model applied to a contract modification depends on a number of factors, including the pricing of the modification, whether any new goods or services added by the modification are distinct and whether any remaining goods or services are part of a partially satisfied single performance obligation. Analysis of these elements will determine whether the modification should be accounted for as: (a) a separate contract, (b) the termination of one contract and execution of a new contract (prospective treatment) or (c) an adjustment to the original contract (resulting in a cumulative catch-up adjustment).

The following chart walks through the application of the new model to a contract modification:



Example 1: Accounting for the modification of a services contract

A federal government contractor enters into a five-year contract to provide daily IT support services. The customer promises to pay \$200,000 per year. The standalone selling price of the services at contract inception is \$200,000 per year. The entity recognizes revenue of \$200,000 per year during the first 4 years of providing services. At the end of the fourth year, the contract is modified and the fee for the fifth year is reduced to \$180,000. In addition, the customer agrees to extend the contract for 2 additional years for consideration of \$300,000 payable in 2 equal annual installments of \$150,000 at the beginning of years 6 and 7. The standalone selling price of the services for years 6 and 7 at the beginning of the fifth year is \$180,000 per year. The entity's standalone selling price at the beginning of the fifth year, multiplied by the additional 2 years of services, is \$360,000, which is deemed to be an appropriate estimate of the standalone selling price of the multiyear contract.

The entity accounts for the IT support services as a single performance obligation because the daily services are a series of distinct services that are substantially the same and have the same

pattern of transfer to the customer (the services transfer to the customer over time and use the same method to measure progress—that is, a time-based measure of progress).

Although the additional services to be provided are distinct, the price change does not reflect the standalone selling price at the date of the modification. As a result, the entity accounts for the modification prospectively as if it were a termination of the original contract and the creation of a new contract with consideration of \$480,000 for 3 years of cleaning service. The entity recognizes revenue of \$160,000 per year ($\$480,000 \div 3$ years) as the services are provided over the remaining 3 years.

Example 2: Accounting for a disputed contract claim involving a change to the contract price

The following example is *Example 9—Unapproved Change in Scope and Price* from ASC 606-10-55-134 to 55-135:

An entity enters into a contract with a customer to construct a building on customer-owned land. The contract states that the customer will provide the entity with access to the land within 30 days of contract inception. However, the entity was not provided access until 120 days after contract inception because of storm damage to the site that occurred after contract inception. The contract specifically identifies any delay (including force majeure) in the entity's access to customer-owned land as an event that entitles the entity to compensation that is equal to actual costs incurred as a direct result of the delay. The entity is able to demonstrate that the specific direct costs were incurred as a result of the delay in accordance with the terms of the contract and prepares a claim. The customer initially disagreed with the entity's claim.

The entity assesses the legal basis of the claim and determines, on the basis of the underlying contractual terms, that it has enforceable rights. Consequently, it accounts for the claim as a contract modification in accordance with paragraphs 606-10-25-10 through 25-13. The modification does not result in any additional goods and services being provided to the customer. In addition, all of the remaining goods and services after the modification are not distinct and form part of a single performance obligation. Consequently, the entity accounts for the modification in accordance with paragraph 606-10-25-13(b) by updating the transaction price and the measure of progress toward complete satisfaction of the performance obligation. The entity considers the constraint on estimates of variable consideration in paragraphs 606-10-32-11 through 32-13 when estimating the transaction price.

RSM commentary: While the entity has incurred costs due to the delay in getting access to the customer-owned land, incurrence of those costs does not result in the transfer of promised goods or services in the contract, so no revenue should be recognized upon filing the claim with the customer. Hence, if the entity uses a cost-based measure of progress toward completion of the contract, it will exclude from that measure the costs associated with the delay.

Because the entity has enforceable rights under the contract to file a claim for the delay costs it incurred, it generally would add the claim amount to the transaction price as variable consideration. The entity should estimate the amount of the claim using either the most likely amount method or the expected value method (see Section C.3.2.1) and include the estimate in the transaction price (subject to the variable consideration constraint discussed in Section C.3.2.2).

C.2 Identify the performance obligations in the contract

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. The first step in identifying the performance obligations in the contract is to identify all of the promises to provide goods or services in the

contract. Once that step is complete, criteria are applied to determine whether the promises to provide goods or services should be treated as performance obligations and accounted for separately.

C.2.1 Identifying promises to transfer goods or services

An entity should scrutinize its customer contracts and identify all promises to transfer goods or services to the customer. Not all activities performed by the entity in connection with the customer contract transfer a good or service to the customer. For example, setup activities do not transfer a good or service to the customer. Instead, those activities are necessary for the entity to fulfill the contract and do not themselves represent a good or service transferred to the customer. As a result, they cannot represent a performance obligation for which revenue is recognized. However, depending on the facts and circumstances, the entity may be required to capitalize the costs to perform these activities under ASC 340-40 (see Section D.1).

Federal government contractors should give consideration to whether there are promises to transfer goods or services that arise out of an entity's customary business practices instead of an explicit contract provision. If an entity's customary business practice, published policy or specific statement creates a valid expectation on the customer's part to receive a good or service from the entity (e.g., training on how to use purchased equipment), an implicit promise to transfer goods or services exists that should be accounted for just like explicit promises to transfer goods or services.

C.2.2 Separating promises to transfer goods or services into performance obligations

If there is more than one promise to transfer goods or services in a contract, consideration must be given to whether the promises to transfer goods or services should each be considered performance obligations and treated separately for accounting purposes. The determining factor in this analysis is whether each promised good or service is distinct. If a promised good or service meets both of the following criteria, it is considered distinct and accounted for separately as a performance obligation unless the series exception applies (see Section C.2.2.1)

- *Capable of being distinct.* If a customer can benefit from the promised good or service (or a bundle of goods or services) on its own or by combining it with other resources readily available to the customer, then the good or service is capable of being distinct. A promised good or service is capable of being distinct when the entity regularly sells that good or service separately or when the customer can generate an economic benefit either on its own or when combined with other readily available resources. The ability to sell the good or service for scrap value only would not, in and of itself, support a conclusion that the promised good or service is capable of being distinct. For a resource to be readily available to the customer, it must be sold separately either by the entity or another party or it must be a good or service that the customer already has obtained as a result of either a contract with the entity (including the contract under evaluation) or another transaction or event.
- *Distinct within the context of the contract.* If the promised good or service is separately identifiable from other promised goods or services in the contract, it is distinct within the context of the contract. To determine whether a promised good or service is distinct within the context of the contract, the entity must ascertain which of the following best describes its promise within the context of the specific contract:
 - *The promise within the context of the specific contract is to transfer the promised good or service individually.* If this best describes the entity's promise within the context of the specific contract, the promised good or service is distinct within the context of the contract.
 - *The promise within the context of the specific contract is to transfer a combined item or items to which the promised good or service is an input.* If this best describes the entity's promise within the context of the specific contract, the promised good or service is not distinct within the context of the contract.

Indicators are provided to assist in determining whether a promised good or service is distinct within the context of the contract. Answering yes to any of the following questions is an indication that the promised good or service is *not* distinct within the context of the contract:

- Is the entity providing a significant service of integrating the promised good or service with one or more of the other promised goods or services in the contract, with the result of that integration being one or more of the combined outputs contracted for by the customer?
- Does the promised good or service significantly modify or customize one or more of the other promised goods or services in the contract, or is the promised good or service significantly modified or customized by one or more of the other promised goods or services in the contract?
- Is the promised good or service highly interdependent or highly interrelated with one or more of the other promised goods or services in the contract, such that each of the promised goods or services is significantly affected by one or more of the other promised goods or services?

If a promised good or service is not distinct, it is combined with the other promised goods or services until the group of promised goods or services is considered distinct, at which point that group is considered a performance obligation and accounted for separately. It is possible that all of the promised goods or services in the contract might have to be accounted for as a single performance obligation. This happens when none of the promised goods or services are considered distinct on their own or together with less than all of the other promised goods or services in the contract.

As noted in paragraph 11.2.08 of the Revenue Recognition AAG, an important factor in determining whether goods or services should be combined with integration services (e.g., contract management services) into a single performance obligation is whether the integration service risks are inseparable from the risks involved in transferring the other promised goods or services. Further, careful consideration should be given to the significance of integration services in situations in which there are services being provided or structures being built.

Example 3: Identifying the performance obligation when providing an integrated service

A federal government contractor, enters into a contract to provide food service management for an army base overseas. The entity is responsible for the overall management of the project and identifies various promised goods and services, including meal planning, ordering ingredients and having them delivered to the base, preparing the food and serving the meals to the base personnel. These promises can be fulfilled by the federal government contractor directly, or through any subcontractors it procures.

The promised goods and services are capable of being distinct in that the customer could benefit from the various services either on their own or together with other readily available resources. However, the promises to transfer the goods and services are not distinct within the context of the contract. This is evidenced by the fact that the entity provides a significant service of integrating the goods and services (the inputs) into the food service management solution (the combined output) for which the customer has contracted.

Because both criteria in paragraph 606-10-25-19 are not met, the goods and services are not distinct. The entity accounts for all of the goods and services in the contract as a single performance obligation.

The importance of properly identifying the performance obligation(s) in a contract becomes clear when considering how accounting for a contract would differ if the entity reached an improper conclusion about identified performance obligation(s). In example 3, reaching an improper conclusion could have resulted in the entity identifying multiple performance obligations (e.g., one for each promised good or service) instead of a single performance obligation. If multiple performance obligations had been improperly identified, the entity would have had to estimate the standalone selling prices of each performance obligation, allocate the transaction price to each performance obligation using the relative standalone

selling price method (see Section C. 4) and determine whether the transaction price allocated to each performance obligation should be recognized over time (and if so, the method of measuring progress toward complete satisfaction of the performance obligation) or at a point time (and if so, the point in time control of the underlying goods or services transfers to the customer). Improperly accounting for the contract in this manner would likely provide significantly different accounting results compared to properly accounting for the contract as one with a single performance obligation.

C.2.2.1 Series of distinct goods or services

If a promised good or service is distinct, it is considered a performance obligation to be accounted for separately. However, a series of distinct promised goods or services that is substantially the same should be considered a *single* performance obligation and accounted for as one unit of account if each of the goods or services has the same pattern of transfer to the customer as a result of: (a) each of the goods or services otherwise being considered satisfied over time (see Section C.5.1) and (b) the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services (see Section C.5.1.3). This exception is commonly referred to as the series exception.

Many professional service contracts entered into by federal government contractors would meet the series exception. For example, contracts where the entity promises to stand ready to provide any necessary services from day to day (such as claims processing, maintenance, or hosting services) would be accounted for under the series guidance.

C.3 Determine the transaction price

C.3.1 General requirements

The transaction price, which is the amount ultimately recognized as revenue under the new guidance, is defined in ASC 606-10-32-2 as “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes).” In addition to the contract terms, the entity’s customary business practices also should be taken into consideration in determining the transaction price.

The transaction price is determined at contract inception and should include any fixed cash consideration and any noncash consideration promised by the customer. The transaction price also should reflect the expected effects of any variable consideration (subject to an overall constraint), such as performance bonuses and penalties. Depending on the facts and circumstances, the transaction price also may be affected by a significant financing component and consideration payable to the customer. When a contract includes a significant implicit or explicit benefit of financing to either the entity or the customer (i.e., a significant financing component), that significant financing component is taken into consideration in determining the transaction price. However, the new guidance specifically indicates that a significant financing component does *not* exist if there are reasons not related to financing that justify the nature and amount of the difference between the cash selling price of the promised goods or services and promised consideration. Furthermore, the entity can elect a practical expedient to ignore the effects of financing if the entity expects the difference between the following two events to be one year or less at contract inception: (1) the entity’s transfer of the promised goods or services to the customer and (2) customer payment for those goods or services.

Issues encountered by federal government contractors in determining the transaction price typically involve variable consideration, which is discussed in more detail in the following section.

C.3.2 Variable consideration

Variable consideration in federal government contracts can take many forms, including award fees, performance and cost-target incentives, reimbursement for expenses not to exceed certain thresholds and provisions for penalty and incentive payments. The variability in the consideration could affect

whether the entity is entitled to the consideration (e.g., achieving or not achieving a cost savings threshold to which a performance bonus is tied) and (or) the specific amount of consideration the customer ultimately will have to pay (e.g., the performance bonus to which an entity will be entitled depends on the results of the project). For variable consideration other than a sales or usage-based royalty for which the only or predominant item to which the royalty relates is the license of intellectual property, determining the amount of variable consideration that should be included in the transaction price typically involves the following two steps: (1) estimating the variable consideration to which the entity expects to be entitled (see Section C.3.2.1) and (2) constraining the amount of variable consideration such that it is probable that the inclusion of the estimate in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved (see Section C.3.2.2).

C.3.2.1 Estimating variable consideration

One of two methods must be used to estimate the variable consideration to which the entity expects to be entitled: (1) the most likely amount method or (2) the expected value method. The entity must use the method that is expected to better predict the amount to which the entity expects to be entitled. In applying either of these methods, the entity should consider all reasonably available information (historical, current and forecasted) along with a reasonable number of possible consideration amounts. A federal government contractor is likely to use information for estimation purposes similar to that used in bid and proposal processes, analyzing information used to determine contract prices, as well as its history with the type of variable consideration in similar situations. In addition, the same estimation method should be used when accounting for contracts with similar characteristics in similar circumstances. However, to the extent a contract includes two different variable payment streams based on the resolution of different uncertainties, the facts and circumstances may support using different methods to estimate the variable consideration expected upon the resolution of each uncertainty.

ASC 606 does not provide any hard-and-fast rules related to when the expected value method or most likely amount method would provide the best prediction. However, the use of the most likely amount method may be appropriate when few outcomes are possible, such as when estimating a fixed-amount performance bonus (e.g., the bonus is 100 percent or nothing). Further, the use of the expected value method, which involves applying probability weighting to several possible outcomes, may be appropriate when there are a large number of contracts with similar characteristics or there is a wide range of possible outcomes, such as for cost-target incentives.

The estimated variable consideration must be reassessed each reporting period until the underlying uncertainty is resolved. The method used to initially estimate the variable consideration also should be used when the estimate is reassessed each reporting period. To the extent a federal government contractor's estimates of the amounts it expects to collect change frequently or change to a significant extent, it should reassess the estimation process it has in place for variable consideration, including the variable consideration constraint discussed in Section C.3.2.2.

To illustrate the two methods that may be used to estimate the amount of variable consideration to which the entity expects to be entitled, and the difference between them, consider the following example.

Example 4: Illustrating how to estimate variable consideration using the expected value method and the most likely amount method

Company A enters into a professional services contract with the federal government to perform an efficiency study of an agency's departments and identify potential cost savings. Company A commits to identifying minimum cost savings totaling 3 percent of the agency's annual budget in exchange for a fixed fee of \$200,000. To incent Company A to identify additional cost savings, the government agrees to pay Company A up to an additional 8 percent incentive fee based on a combination of quantitative thresholds and qualitative criteria to be evaluated by the government's project manager. Based on its

past experience with similar customers and projects, Company A assigns the following probabilities to the earning an additional incentive fee, which results in the following estimates of variable consideration using the expected value method and most likely amount method:

Additional Incentive fee earned	Incentive payment	Probability	Probability-weighted average
0% of fixed fees	\$ -	10%	\$ -
2% of fixed fees	4,000	10%	400
5% of fixed fees	10,000	60%	6,000
8% of fixed fees	16,000	20%	3,200
Variable consideration estimated using the expected value method			\$9,600
Variable consideration estimated using the most likely amount method			\$10,000

Company A does not have a free choice with respect to using either the expected value method or most likely amount method. It must analyze all of its facts and circumstances and determine which method better predicts the amount of variable consideration in those facts and circumstances. Making this determination will require significant judgment to be exercised and careful consideration of all the facts and circumstances.

Application of the variable consideration constraint (see Section C.3.2.2) was not applied to this example.

As noted in paragraph 11.3.06 of the Revenue Recognition AAG, substantial judgment and experience may be needed in determining whether results of performance will meet the targeted objectives. As a result, performance incentives should not automatically be included in the transaction price, but instead should be evaluated as variable consideration to determine the amount to include with the transaction price.

C.3.2.2 Variable consideration constraint

Once the entity has estimated the amount of variable consideration to which it expects to be entitled, it then needs to apply the constraint, focused on whether it is probable that the inclusion of the estimated variable consideration in the transaction price will not result in a significant reversal of cumulative revenue recognized for the contract when the uncertainty giving rise to the variability is resolved. Only estimated variable consideration for which it is probable that its inclusion in the transaction price will not result in a significant reversal of cumulative revenue recognized should be included in the transaction price. If it is probable that a significant reversal of cumulative revenue recognized will not occur with respect to just a portion of the estimated variable consideration to which the entity expects to be entitled, that portion would be included in the transaction price.

The TRG discussed whether the constraint on variable consideration should be applied at the contract level or the performance obligation level. The basis for its conclusions is provided in TRG 14, and the summary of discussions is provided in TRG 25 paragraph 49 as follows:

...TRG members generally agreed that the constraint on variable consideration should be applied at the contract level. Therefore, the assessment of whether a significant reversal of revenue will occur in the future (the constraint) should consider the estimated transaction price of the contract rather than the amount allocated to a performance obligation.

If a federal government contractor's process for estimating variable consideration already considers the underlying principles on which the variable consideration constraint guidance was based, then effectively the constraint has been evaluated concurrently with estimating the variable consideration amount and the contractor does not have to evaluate the constraint separately.

Factors (depending on their likelihood and magnitude) to consider when applying the variable consideration constraint and assessing whether it is probable that a significant reversal of cumulative revenue recognized will not occur include, but are not limited to:

- *To what extent is the amount of consideration influenced by factors not within the federal government contractor's control?* The greater the extent to which the amount of consideration is determined by third parties (e.g., customer, regulator, supplier, subcontractor, arbitration judgments) and not within federal government contractor's control, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the amount estimated should be constrained. Other factors to consider include volatility in the market, weather conditions and a high risk of obsolescence of the promised goods or services.
- *How much experience does the federal government contractor have with similar customers?* The less experience the federal government contractor has with similar types of projects, markets, contracts and variable consideration amounts (or predictive evidence thereto), the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained.
- *How uncertain is the federal government contractor about when it will collect the variable amounts owed by its customers?* The longer it takes a federal government contractor to resolve disputes, claims or unapproved change orders or earn variable fees, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained.
- *To what extent does the federal government contractor offer a broad range of price concessions or change payment terms and conditions of similar contracts in similar circumstances?* The more the federal government contractor changes the availability and amount of price concessions offered to its clients, the more likely it is that a significant reversal of cumulative revenue recognized could occur. The greater the degree of uncertainty that actual amounts will differ from expected amount, the more likely it is that the estimated amount should be constrained.
- *How broad is the range of possible consideration amounts?* The more volatile the range of possible consideration amounts, the more likely it is that a significant reversal of cumulative revenue recognized could occur and the estimate should be constrained. This factor often is linked to an entity's experience and ability to accumulate historical data.

The analyses of many of these factors may change over time as a federal government contractor gets more experience with the variable consideration guidance and estimates of variable consideration should be updated each reporting period. The entity also should revise its measure of progress (e.g., estimated costs to complete the contract) as necessary as variable consideration estimates are updated.

C.3.2.3 Unfunded contracts

Because of the federal government's budgeting process, it is common for the government to enter into long-term contracts that are only partially funded. In such instances, the federal government contractor will first need to evaluate whether a contract exists for both the funded and unfunded portions of the contract. This evaluation may depend on the nature of the goods or services being provided. For example, in a construction or aerospace contract, the federal government contractor is likely to determine that the contract existence criteria are met for both the funded and unfunded portions because the federal government would not enter into a contract for a partially built building, ship or airplane, which indicates that the federal government has the ability and intention to pay for all the promised goods and services in the contract, including the unfunded portion. As noted in footnote 1 of paragraph 3.1.11 of the Revenue

Recognition AAG, this evaluation should consider the likelihood of contract cancellation and if it is determined that cancellation would occur only upon some remote contingency, the contract should be considered noncancellable. If, on the other hand, the federal government contractor is providing a monthly service and the contract does not include any terms or conditions that would indicate that the federal government is committed to fund the contract in the future, only the funded portion may qualify as a contract.

If the federal government contractor determines that both the funded and unfunded portions of the contract meet the contract existence criteria, the unfunded portion should be considered variable consideration. The federal government contractor will therefore need to estimate the amount of consideration to which it will be entitled, assuming that all goods and services will be transferred to the customer in accordance with the contract terms. It will then need to constrain that amount and recognize revenue only to the extent that it is probable that a significant reversal of revenue will not occur. As part of this estimation process, the federal government contractor should assess the likelihood that the unfunded portion will be funded, which includes considering the following factors suggested in paragraph 3.1.14 of the Revenue Recognition AAG:

- a. Whether there is a short period of time before contract funding is expected
- b. Whether the work is sole source, a follow-on effort, or there is high competition
- c. Whether customer funding and budget exist and the task of processing the funding is administrative only
- d. Whether it is a major program or the customer is in critical need of the program
- e. Whether there has been communication from the customer that funding will be obtained
- f. Whether the entity has a history of receiving funding in similar situations

A federal government contractor is required to update its estimates of incentives and penalties on an ongoing basis, even if the beginning estimate is zero.

Example 5: Evaluating unfunded portions of a contract

The following example is from the Revenue Recognition AAG, Example 3-1-1:

On September 1, 20X1, an aerospace and defense contractor signed a contract with the U.S. federal government for a fixed price of \$600 million over a three-year period of performance. The program will receive annual funding of \$200 million, starting on September 30, 20X1. The entity concludes that the entire \$600 million contract is within the scope of the revenue standard because the entity has an approved contract in writing signed by both parties, it clearly identifies each party's rights regarding goods and services to be delivered, the payment terms are clearly identified, and collectibility is probable because the customer has both ability and intent to pay.

On August 1, 20X2, the entity has recognized revenue of \$200 million based on costs to date (plus a reasonable profit margin). In deciding whether to continue performing and recognizing revenue on the contract beyond funding, the entity analyzes the probability that it will receive funding and, therefore, not incur a significant reversal of cumulative revenue recognized. The entity considers the following factors:

- Time period before contract funding is expected is short (two months).
- Program is a follow-on contract.
- U.S. federal government has both the ability and intention to pay.
- U.S. federal government has a need for the program.
- Entity has received communication from the customer that funding will be obtained.

- Historically, the entity was able to receive funding and recover its costs on contracts that led up to this follow-on work.

Based on these considerations, the entity concludes that the risk of a significant reversal of cumulative revenue is remote and, therefore, the unfunded amounts are included in the transaction price and recognized as revenue.

RSM commentary: In most cases, not all of the factors indicating whether the government will fund a contract will align and the federal government contractor will need to exercise judgement in considering the importance of each factor. For example, assume all the same facts in this example except that the government has expressed uncertainty about the need for the program and the entity has not received communication from the customer that the funding will be obtained. In that scenario, the federal government contractor would likely conclude that it is not probable that a significant reversal of revenue will not occur if it includes the unfunded portion of the contract in the transaction price, and would therefore need to constrain the transaction price and not recognize revenue for the unfunded portion of the contract. It would need to update its evaluation each period until the funding is provided or the contract is terminated.

C.4 Allocate the transaction price to the performance obligations

If a customer contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations. In addition, a customer contract with one performance obligation also may be affected by the guidance on allocating variable consideration when that one performance obligation is made up of a series of distinct goods or services that are treated as a single performance obligation under the series exception.

The standalone selling price of a performance obligation is the amount the entity charges (or would charge) when the distinct goods or services that make up the performance obligation (i.e., the underlying distinct goods or services) are sold on their own to a customer. Standalone selling prices are determined at contract inception and are not subsequently adjusted for changes in facts and circumstances.

The best evidence of the standalone selling price of the underlying goods or services is the observable price charged by the entity for those goods or services when they are sold separately in similar circumstances to similar customers. Absent evidence of a directly observable standalone selling price, the entity is required to estimate a standalone selling price. In making this estimate, the entity should maximize observable inputs and consider all reasonably available and relevant information, which includes information specific to the entity, the market, the customer and the customer class. In addition, an entity should be consistent in how it applies an estimation method and the situations in which it applies an estimation method.

While there are any number of approaches to estimating a standalone selling price that are consistent with the overall objective of allocating the transaction price, ASC 606 discusses the following three approaches:

- Adjusted market assessment approach.* This approach identifies the price at which customers would be willing to buy the underlying goods or services on a standalone basis, which might include looking at prices charged by competitors for similar goods or services and making the appropriate entity-specific adjustments.
- Expected cost plus a margin approach.* This approach builds up a standalone selling price for the underlying goods or services using the costs the entity expects to incur to provide the goods or services and adding an appropriate margin to those costs.

- *Residual approach.* This approach may only be used when there is an observable standalone selling price for the other performance obligation(s) in the contract and one of the following criteria is met: (a) the prices at which the entity has sold the goods or services on a standalone basis at or near the same time represent a broad range of prices within which a representative standalone selling price cannot be identified (i.e., the selling price is highly variable) or (b) the goods or services underlying a performance obligation have not previously been sold on a standalone basis and the entity has not yet established a price for those goods or services (i.e., the selling price is uncertain). The standalone selling price of the goods or services to which the residual approach is applied is calculated by determining the difference (i.e., residual) between: (a) the total transaction price and (b) the total observable standalone selling prices for the other goods or services in the contract.

These approaches to estimating the standalone selling price of a performance obligation may only be used when the performance obligation does not have an observable standalone selling price. Upon estimating a standalone selling price using any of these methods, the entity should ensure that the outcome is consistent with the objective of identifying the amount the entity would charge if it sold the underlying good or service on its own (or the underlying group of goods or services on its own).

C.5 Recognize revenue when (or as) each performance obligation is satisfied

Revenue is recognized when (or as) a performance obligation is satisfied, which is when control of the underlying good or service (i.e., an asset) is transferred to the customer. The amount of revenue recognized upon satisfaction of a performance obligation is the transaction price allocated to it. To properly assess when revenue should be recognized, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time.

Control of an asset has transferred to a customer when the customer has the ability to direct the use of the asset and receive substantially all of the related remaining benefits, which includes being able to stop others from directing the use of the asset and receiving substantially all of the related remaining benefits. For this purpose, benefits are considered in terms of the potential cash flows the customer can obtain or save (directly or indirectly) as a result of having control of the asset.

ASC 606 provides several indicators that should be considered in assessing whether control of an asset has transferred to the customer. When present, the following indicators may signal that the customer has the ability to direct the use of the asset (and restrict others' use of the asset) and receive substantially all of the asset's remaining benefits:

- The customer is presently obligated to pay the entity for the transferred asset.
- The customer has legal title to the transferred asset.
- The customer has physical possession of the transferred asset.
- The customer has the significant risks and rewards of owning the asset.
- The customer has accepted the asset.

For purposes of determining whether the significant risks and rewards of owning the asset have transferred to the customer, the entity should only consider the risks associated with owning the asset included in the performance obligation for which control transfer is being evaluated and not the risks associated with owning the asset(s) included in other performance obligations in the contract for which control transfer will be separately evaluated.

C.5.1 Determine whether a performance obligation is satisfied over time or at a point in time

As indicated earlier, an entity must perform an evaluation at contract inception focused on whether a performance obligation is satisfied over time or at a point in time. If a performance obligation meets one or more of the following criteria, it is considered satisfied over time:

- *Customer simultaneously receives and consumes benefits as entity performs.* A performance obligation is satisfied over time if the customer consumes the benefits of the entity's performance at the same time as: (a) the customer receives those benefits and (b) the entity performs and creates those benefits. In some situations, it will be readily apparent that the customer is simultaneously receiving and consuming the benefits as the entity performs, such as in certain service arrangements. Situations in which the entity's performance results in the creation or enhancement of an asset do not qualify for over time recognition under this criteria as the asset cannot be simultaneously received and consumed by the customer. For those situations in which the entity's performance creates or enhances an asset, the entity should consider whether one of the other two criteria are met. If it is not readily apparent whether this criterion is met for a particular set of facts and circumstances, then a performance obligation is satisfied over time if another entity could step in and fulfill the remaining performance obligation without having to substantially reperform the work already performed by the entity.
- *Customer controls the asset as the entity creates or enhances the asset.* A performance obligation is satisfied over time if the customer controls the asset (which could be tangible or intangible) as it is created or enhanced by the entity's performance. An entity will need to carefully consider the indicators of control discussed previously in Section C.5 in assessing whether control of the asset passes to the customer as the entity performs. An example of a performance obligation that might meet this criterion, depending on all the facts and circumstances, is a construction contract in which the entity is building a facility on government-owned land.
- *No alternative use and an enforceable right to payment.* A performance obligation is satisfied over time if: (a) the asset created by the entity's performance does not have an alternative use to the entity upon its completion (see Section C.5.1.1) and (b) the entity's right to payment for its performance to date is enforceable (see Section C.5.1.2).

If a performance obligation does not meet any of these three criteria, then it is considered satisfied at a point in time and revenue is recognized at the point in time the customer obtains control over the underlying good or service. The same criteria are evaluated regardless of whether the performance obligation includes one or more promised goods or services. In addition, these criteria include no predispositions that will result in a performance obligation that includes a promised good being satisfied at a point in time or a performance obligation that includes a promised service being satisfied over time. Each performance obligation should be evaluated against these indicators to determine whether revenue should be recognized over time or at a point in time.

If the performance obligation is considered satisfied over time, the related revenue is recognized over time using a single method of measuring progress over time. The objective of the method selected should be to measure the progress made in transferring control of the underlying goods or services to the customer. The method selected should be applied consistently to similar performance obligations in similar circumstances.

C.5.1.1 No alternative use

In performing the assessment as to whether the asset has an alternative use to the entity, an entity needs to determine the nature and substance of any legal, contractual or practical limitations on its ability to redirect (e.g., sell to another customer) the completed asset created by its performance. The asset does not have an alternative future use to the entity if the entity is either contractually restricted or practically limited from directing the asset for another use. For this purpose:

- *Contractual restriction.* A contractual restriction must be substantive and enforceable. In other words, to conclude that the asset has no alternative use to the entity, the customer must be able to enforce its right to obtain the asset if the federal government contractor tries to use it for another purpose. In addition, that right must be meaningful, which would not be the case if the asset in question is readily interchangeable with other assets that the federal government contractor could use to satisfy its obligation to the customer, without putting it in breach of contract or causing it to incur significant incremental costs.
- *Practical limitation.* If a practical limitation would result in an entity experiencing significant economic losses as a result of redirecting the asset for another use, the asset has no alternative use to the entity. Examples of situations in which a federal government contractor could experience significant economic losses when trying to redirect the asset for another use include: (a) incurring significant costs to rework an asset because it was built to the original customer's specifications and (b) selling the asset for a significant loss because it had to be moved from the remote area in which it was built as specifically requested by the original customer.

In addition, the entity does not consider the possibility that the customer contract could be terminated when assessing whether it could redirect the asset for another use.

Example 6: Determining whether a satellite has an alternative use to the entity

The following example is *Example 15—Asset Has No Alternative Use to the Entity* from ASC 606-10-55-165 to 55-168:

An entity enters into a contract with a customer, a government agency, to build a specialized satellite. The entity builds satellites for various customers, such as governments and commercial entities. The design and construction of each satellite differ substantially, on the basis of each customer's needs and the type of technology that is incorporated into the satellite.

At contract inception, the entity assesses whether its performance obligation to build the satellite is a performance obligation satisfied over time in accordance with paragraph 606-10-25-27.

As part of that assessment, the entity considers whether the satellite in its completed state will have an alternative use to the entity. Although the contract does not preclude the entity from directing the completed satellite to another customer, the entity would incur significant costs to rework the design and function of the satellite to direct that asset to another customer. Consequently, the asset has no alternative use to the entity (see paragraphs 606-10-25-27(c), 606-10-25-28, and 606-10-55-8 through 55-10) because the customer-specific design of the satellite limits the entity's practical ability to readily direct the satellite to another customer.

For the entity's performance obligation to be satisfied over time when building the satellite, paragraph 606-10-25-27(c) also requires the entity to have an enforceable right to payment for performance completed to date. This condition is not illustrated in this Example.

C.5.1.2 Enforceable right to payment

In performing the assessment as to whether an enforceable right to payment for performance to date exists, the entity must be able to conclude, based on the terms of the contract and applicable laws, that it is entitled to proportionate compensation for its performance to date at all times during the contract if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as promised. For this purpose: (a) an entity is not necessarily required to conclude that it has a present unconditional right to payment and (b) the amount to which the entity is entitled does not have to be a fixed amount.

To draw an appropriate conclusion as to whether the entity has an enforceable right to payment (by either demanding payment or retaining payment) for its performance completed to date if the contract were to be terminated by the customer or another party for reasons other than the entity not performing as

promised, a federal government contractor should ensure it has a complete understanding of all the relevant facts and circumstances. Further, it is not just a matter of the entity having an enforceable right to payment for its performance completed to date. The payment itself must represent proportionate compensation for the entity's performance. Proportionate compensation would be an amount roughly equivalent to what the selling price would be for what the entity has completed to date. ASC 606-10-55-11 indicates the following:

An amount that would compensate an entity for performance completed to date would be an amount that approximates the selling price of the goods or services transferred to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin) rather than compensation for only the entity's potential loss of profit if the contract were to be terminated. Compensation for a reasonable profit margin need not equal the profit margin expected if the contract was fulfilled as promised, but an entity should be entitled to compensation for either of the following amounts:

- a. A proportion of the expected profit margin in the contract that reasonably reflects the extent of the entity's performance under the contract before termination by the customer (or another party)
- b. A reasonable return on the entity's cost of capital for similar contracts (or the entity's typical operating margin for similar contracts) if the contract-specific margin is higher than the return the entity usually generates from similar contracts.

If a performance obligation is part of a contract priced at a loss, the entity has an enforceable right to payment for its performance to date if it is entitled to a proportionate amount of the performance obligation's selling price.

As noted in paragraph 11.5.04 of the Revenue Recognition AAG, under a termination for convenience clause, the federal government contractor is generally entitled to recover all costs incurred to the termination date, plus other costs not recovered at termination (such as ongoing costs not able to be discontinued), as well as an allowance for profit. The federal government also typically has a right to any work-in-process as of the termination date.

Example 7: Determining whether an enforceable right to payment for performance completed to date exists when there is a termination for convenience clause

A software developer enters into a contract with the federal government to create a customized software system for \$1 million due upon delivery of the software to the government. The contract includes a clause which gives the government the right to unilaterally terminate the contract at any time with or without giving a reason. If the federal government were to exercise the clause, the contract states that the software developer would be entitled to a negotiated settlement amount and the government would have the right to any in-process work or IP developed. The contractual restrictions therefore result in the software developer creating an asset that has no alternative use to the entity. The entity's legal counsel has concluded that the negotiated amount the federal government contractor is entitled to would be an amount equal to the recovery of costs and losses incurred, as well as an allowance for profit or fee. The developer therefore concludes that revenue for the software contract should be recognized over time as the software is being developed.

C.5.1.3 Recognizing revenue for performance obligations satisfied over time

If the performance obligation is considered satisfied over time, the related revenue is recognized over time if the entity is able to reasonably measure its progress toward complete satisfaction of the performance obligation using reliable information. The entity must identify a single method by which to make that measurement.

Output methods or input methods can be used to measure progress toward complete satisfaction of performance obligations. Regardless of which is used, the measurement of progress toward complete

satisfaction of a performance obligation should only reflect the underlying goods or services for which control has transferred to the customer and should not reflect any underlying goods or services for which control has not transferred to the customer. In addition, once a method is selected, it should be consistently applied to similar performance obligations in similar circumstances. To determine the method that best depicts progress toward complete satisfaction of a performance obligation, contractors should consider matters such as the nature of goods and services, specific contract terms such as contract termination rights and ability to demand or retain payments, and which party has title to the work in process.

Progress toward completion is calculated at the end of each reporting period and used in determining the appropriate amount of revenue to recognize in that period. The calculation is based on the amount of outputs or inputs to date and the estimated total amount of outputs or inputs necessary to satisfy the performance obligation. Prior to measuring progress toward completion at the end of a reporting period, the entity should consider whether the estimated total amount of outputs or inputs necessary to satisfy the performance obligation should be updated. Any updates to the estimates not caused by a contract modification or certain other factors (e.g., significant unexpected inefficiencies experienced by the entity) should be accounted for as a change in estimate in accordance with ASC 250, "Accounting Changes and Error Corrections."

C.5.1.3.1 Output methods. Output methods rely on the value of underlying goods or services included in the performance obligation. Examples of output methods that may be appropriate to apply (depending on the facts and circumstances) include:

- Surveying or appraising the value of the results achieved and comparing that amount to the value of the results expected from satisfying the performance obligation
- Determining the units produced or units delivered and comparing that amount to the total units included in the performance obligation that are expected to be produced or delivered
- Comparing time elapsed in satisfying the performance obligation with the time period over which the performance obligation is satisfied
- Identifying the milestones reached and comparing those milestones to all of the milestones that must be reached in connection with satisfying the performance obligation

A particular output method should only be used if the measure of progress it produces is consistent with how control of the goods or services transfers to the customer. As a result, care should be exercised to ensure an output method reflects all of the goods or services in the performance obligation for which control has transferred to the customer (even those goods or services that are partially completed). For example, if an entity plans to use a units-produced or units-delivered method, it should ensure that there is no work in process inventory for which control has passed to the customer because such inventory would not be included in the measure of units produced or units delivered, by definition. As discussed in paragraph 11.5.08 of the Revenue Recognition AAG, for contracts that include a termination for convenience clause that gives a customer effective control over the goods produced and work in process, a units-delivered or units-produced output method would not be appropriate as it would ignore the work in process that belongs to the customer. Further, as discussed in paragraph 11.5.18 of the Revenue Recognition AAG, a units-delivered or units-produced output method also may not be appropriate for contracts to provide design and production services as equal value is not delivered to the customer with each unit. However, as noted in paragraph 11.5.20 of the Revenue Recognition AAG, a units of delivery method may be appropriate in certain production-only contracts for homogeneous products.

A practical expedient is provided that allows an entity to use an output method under which revenue is recognized for the amount the entity has a right to invoice the customer if its right to consideration from that customer directly corresponds to the value received by the customer from the entity's performance completed to date. For example, if the customer contract requires the entity to provide operations and

maintenance services to a customer billed at a set rate for each hour of service regardless of the nature or timing of the services provided, the entity may be able to elect this practical expedient. As discussed in paragraph 11.5.13 of the Revenue Recognition AAG however, revenue recognition based on the right to invoice may not be appropriate for certain contracts, such as maintenance service contracts with a significant variable incentive provision paid by the customer infrequently.

While an output method that is appropriately identified and utilized would often provide the best theoretical measure of an entity’s progress in satisfying a performance obligation, in many cases the outputs of a performance obligation are not directly observable. In addition, identifying the value of the outputs produced for a performance obligation that is only partially satisfied may not be feasible without the entity expending undue cost and effort. As a result, input methods are used more often in practice than output methods.

C.5.1.3.2 Input methods. Input methods rely on the efforts put forth by the entity to satisfy the performance obligation. Appropriate input methods typically include labor hours spent, costs incurred, time elapsed or machine hours used. When using an input method, the measurement of progress toward complete satisfaction of a performance obligation should only reflect the inputs related to the underlying goods or services for which control transfers to the customer and should not reflect the inputs related to the underlying goods or services for which control has not transferred to the customer. As a result, an input method should not reflect inputs that relate to activities that are not themselves goods or services, such as setup activities.

If an entity’s efforts or inputs are expended evenly throughout the performance period, it may be appropriate to recognize revenue on a straight-line basis, such as a time-based method.

In some situations, there might not be a direct relationship between the inputs expended by an entity and the amount of underlying goods or services for which control has transferred to the customer. In these situations, the entity must determine whether it can make adjustments to the input method to correct for the lack of a direct relationship or whether it should use a different input method or an output method. For example, if an entity is using a cost-to-cost method of measuring its progress toward the complete satisfaction of a performance obligation and incurs a cost that ultimately does not contribute to satisfying the performance obligation, the entity should remove that cost from both the numerator and denominator of the cost-to-cost measure.

Example 8: Applying a cost-to-cost input method to a change in the estimate of total costs

Company A enters into a contract with Customer B, a veteran affairs nursing home, on September 1, 20X1 for \$100 million to provide facility activation services. Company A will identify challenges associated with moving to a new facility and develop risk mitigation strategies. This includes contingency planning, integration of old and new assets and disposition of old assets no longer needed, operational testing and simulation, tenant management and coordination of the physical move of people, equipment and technology from the old facility to the new. Company A expects the project to take approximately three years, and it estimates it will incur costs totaling \$85 million. The schedule by which Company A bills the \$100 million transaction price is as follows:

Billing date	20X1	20X2	20X3	20X4
March 1	\$ -	\$7,000,000	\$7,000,000	\$7,000,000
June 1	-	7,000,000	7,000,000	7,000,000
September 1	7,000,000	7,000,000	7,000,000	16,000,000
December 1	7,000,000	7,000,000	7,000,000	-
Annual total	\$14,000,000	\$28,000,000	\$28,000,000	\$30,000,000
Contract total				\$100,000,000

Customer B is obligated to pay the amounts billed by Company A within 60 days of the billing date.

Based on its facts and circumstances, Company A concludes the contract includes a single performance obligation. Company A also concludes the contract is satisfied over time because the services provided have no alternative use to Customer A and the contract includes an enforceable right to payment for performance to date, including a margin, if the contract is cancelled.

Company A decides it will use a cost-to-cost method to measure its progress toward completion because:

- Company A has reliable information about the costs it expects to incur and the costs it actually incurs, which will enable it to reasonably measure its progress toward completion of the project.
- Company A concludes using a cost-to-cost method will measure its progress in transferring control to Customer B because as Company A incurs costs, Customer B obtains the benefit of the work performed.

In addition, Company A uses a cost-to-cost method to measure progress toward the complete satisfaction of other performance obligations similar to the one in its contract with Customer B.

As of December 31, 20X1 (its calendar year end), Company A has: (a) incurred costs of \$8,500,000, (b) received the September 1 payment of \$7 million from Customer B and (c) not yet received the December 1 payment of \$7 million from Customer B. In addition, Company A continues to estimate that it will incur total costs of \$85 million.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from September 1, 20X1 to December 31, 20X1:

	Debit	Credit
Cash	\$7,000,000	
Accounts receivable	7,000,000	
Costs	8,500,000	
Revenue (Note 1)		\$10,000,000
Contract liability (Note 2)		4,000,000
Accounts payable (Note 3)		8,500,000

Note 1: \$100,000,000 transaction price × (\$8,500,000 costs incurred ÷ \$85,000,000 total costs expected to be incurred)

Note 2: The contract liability represents the difference between: (a) Customer B's performance (\$7 million payment) and obligation to perform (\$7 million obligation to pay) and (b) Company A's performance (\$10 million).

Note 3: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the \$8.5 million of costs, including cash (e.g., payments for labor costs) and materials inventory.

During the first quarter of 20X2, Company A increases its estimate of total costs by \$2 million.

As a result, Company A estimates its total costs to be \$87 million. Company A has not yet decided whether it will seek a contract modification from Customer B to increase its fee to cover these costs. As of March 31, 20X2, Company A has: (a) incurred total costs to date of \$16,660,000, (b) received the December 1, 20X1 payment of \$7 million from Customer B and (c) not yet received the March 1, 20X2 payment of \$7 million from Customer B.

The following journal entry illustrates the effects of Company A's accounting for its contract with Customer B from January 1, 20X2 to March 31, 20X2:

	Debit	Credit
Cash	\$7,000,000	
Costs (Note 1)	8,160,000	
Contract liability (Note 2)	1,000,000	
Revenue (Note 3)		\$8,000,000
Accounts payable (Note 4)		8,160,000

Note 1: \$16,660,000 total costs incurred – \$8,500,000 costs incurred in prior periods

Note 2: The balance in the contract liability should be \$3 million at March 31, 20X2 because it represents the difference between: (a) Customer B's performance and obligation to perform of \$21 million (which is three payments paid or payable of \$7 million) and (b) Company A's performance of \$18 million (\$10 million of revenue recognized in 20X1 + \$8 million of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was \$4 million at December 31, 20X1. As a result, the balance in the contract liability should be reduced by \$1 million.

Note 3: $(\$100,000,000 \text{ transaction price} \times [(\$15,660,000 \text{ total costs incurred}) \div (\$87 \text{ million total costs expected to be incurred})]) - \$10,000,000$ recognized as revenue in prior periods.

Note 4: Accounts payable was used here for ease of illustration. Other accounts also would be affected as Company A incurred the \$8,160,000 of costs, including cash (e.g., payments for labor costs) and materials inventory.

C.5.2 Loss provisions

Existing guidance in legacy GAAP primarily was retained for the recognition of loss provisions on contracts with customer-provided specifications for facility construction, the production of goods, or provision of related services. ASC 605-35-15-2(a) indicates that the scope of the guidance in ASC 605-35 related to recognizing loss provisions on a contract applies to the following types of contracts entered into by contractors:

The performance of contracts for which specifications are provided by the customer for the construction of facilities or the production of goods or the provision of related services. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design, engineering, procurement, and construction management (see paragraph 605-35-15-3 for examples). Contracts covered by this Subtopic are binding agreements between buyers and sellers in which the seller agrees, for compensation, to perform a service to the buyer's specifications. Specifications imposed on the buyer by a third party (for example, a government or regulatory agency or a financial institution) or by conditions in the marketplace are deemed to be buyer's specifications.

For these purposes: (a) a contractor may be a prime contractor or a subcontractor and (b) a contract is a binding agreement between the contractor and its customer under which the contractor will provide a service to the customer's specifications.

Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, are specifically excluded from the loss provision guidance, but other types of federal government contracts may be impacted.

The following table includes two lists of contracts that are examples of when the loss provision guidance in ASC 605-35 does and does not apply (neither list is comprehensive).

Examples of contracts to which the loss provision guidance in ASC 605-35...	
Does apply	Does not apply
From ASC 605-35-15-3: a. Contracts in the construction industry, such as those of general building, heavy earth	From ASC 605-35-15-6: a. Sales by a manufacturer of goods produced in a standard manufacturing operation, even

Examples of contracts to which the loss provision guidance in ASC 605-35...

Does apply	Does not apply
<p>moving, dredging, demolition, design-build contractors, and specialty contractors (for example, mechanical, electrical, or paving). In general the type of contract here under consideration is for construction of a specific project. While such contracts are generally carried on at the job site, this Subtopic also would be applicable in appropriate cases to the manufacturing or building of special items on a contract basis in a contractor's own plant.</p> <ul style="list-style-type: none"> b. Contracts to design and build ships and transport vessels. c. Contracts to design, develop, manufacture, or modify complex aerospace or electronic equipment to a buyer's specification or to provide services related to the performance of such contracts. d. Contracts for construction consulting service, such as under agency contracts or construction management agreements. e. Contracts for services performed by architects, engineers, or architectural or engineering design firms. f. Arrangements to deliver software or a software system, either alone or together with other products or services, requiring significant production, modification, or customization of software. 	<p>if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as the sale of goods and if their costs are accounted for in accordance with generally accepted principles of inventory costing.</p> <ul style="list-style-type: none"> b. Sales or supply contracts to provide goods from inventory or from homogeneous continuing production over a period of time. c. Contracts included in a program and accounted for under the program method of accounting. For accounting purposes, a program consists of a specified number of units of a basic product expected to be produced over a long period in a continuing production effort under a series of existing and anticipated contracts. d. Service contracts of health clubs, correspondence schools, and similar consumer-oriented entities that provide their services to their clients over an extended period. e. Magazine subscriptions. f. Contracts of not-for-profit entities (NFPs) to provide benefits to their members over a period of time in return for membership dues. g. Contracts for which other Topics in the Codification provide special methods of accounting, such as leases. h. Cost-plus-fixed-fee government contracts, which are discussed in Topic 912, other types of cost-plus-fee contracts, or contracts such as those for products or services customarily billed as shipped or rendered. i. Federal government contracts within the scope of that Topic. j. Service transactions between a seller and a purchaser in which, for a mutually agreed price, the seller performs, agrees to perform at a later date, or agrees to maintain readiness to perform an act or acts, including permitting others to use entity resources that do not alone produce a tangible commodity or product as the

Examples of contracts to which the loss provision guidance in ASC 605-35...

Does apply	Does not apply
	principal intended result (for example, services, not plans, are usually the principal intended result in a transaction between an architect and the customer of an architect).

C.5.2.1 Recognition and measurement

A federal government contractor may elect to recognize and measure loss provisions on contracts within the scope of ASC 605-35 at one of the following two levels:

- *Contract level (or combined contract level).* The contract (or combined contracts) is the unit of account for which a loss provision is recognized and measured (when necessary). Combined contracts should only be the unit of account if the contracts were combined as a result of applying the contract combination guidance in ASC 606 (see Section C.1.3). If loss provisions are recognized and measured at this level, more than one performance obligation may be affected.
- *Performance obligation level.* The performance obligation is the unit of account for which a loss provision is recognized and measured (when necessary).

The same accounting policy must be applied to similar contracts.

If a federal government contractor anticipates a loss on a particular unit of account, the entire anticipated loss should be recognized and measured by the contractor in the period the loss becomes evident. A loss provision is recognized and measured when the current estimate of contract costs exceeds the current estimate of consideration expected to be received. The entire loss is recognized in the period it becomes evident.

C.5.2.2 Current estimate of contract costs

The current estimate of contract costs should include all of the fulfillment costs allocable to a customer contract. Federal government contractors should consider whether there are any costs associated with change orders accounted for as contract modifications (see Section C.1.4) that should be included in the current estimate of contract costs. In addition, for purposes of determining its total cost overrun on a contract, the contractor should use its normal cost accounting methods.

C.5.2.3 Current estimate of consideration expected to be received

The current estimate of consideration expected to be received is determined in accordance with ASC 606 and depends on whether the unit of account for recognizing and measuring a loss provision is the:

- *Contract (or combined contracts).* The current estimate of consideration expected to be received is the transaction price for the contract (or combined contracts) reduced by the amount the contractor does not expect to collect from the customer due to the customer's credit risk and increased by the effects of removing the variable consideration constraint (if any) (see Section C.3.2.2).
- *Performance obligation.* The federal government contractor allocates the current estimate of consideration expected to be received for the contract (or combined contracts) to the performance obligations using the guidance in ASC 606 on allocating the transaction price to the performance obligations (see Section C.4), which results in the current estimate of consideration expected to be received for each performance obligation.

C.5.2.4 Presentation of loss provision

The loss provision for a unit of account should be presented as an additional contract cost on the income statement and should not be: (a) presented as a reduction of revenue or (b) classified as a separate line

item on the income statement unless the amount of the loss is material or the nature of the loss is unusual or infrequent. In those limited situations in which the loss is classified as a separate line item on the income statement, it should still be included in the determination of gross profit.

To the extent a significant liability is recognized related to a loss provision, it should be separately presented on the balance sheet. However, if there are costs accumulated on the balance sheet related to the unit of account, a contractor may choose to recognize the loss provision for that unit of account as a reduction of the accumulated costs instead of recognizing it as a liability. When a separate liability is presented on the balance sheet for a loss provision, it should be classified as a current liability.

D. Contract costs

ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under customer contracts within the scope of ASC 606 should be capitalized. The categories of costs addressed in ASC 340-40 include costs to fulfill a customer contract and incremental costs to obtain a customer contract.

D.1 Costs to fulfill a customer contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a customer contract within the scope of ASC 606, that other guidance should be applied. For example, costs to purchase goods beyond the requirements of an existing contract due to expected future orders likely would be evaluated under ASC 330. Costs to fulfill a customer contract for which there is no other applicable guidance should be capitalized when all of the following criteria are met:

- The costs incurred by the entity are directly related to a specific contract or specific anticipated contract (e.g., design costs of an asset for a specific contract that is pending approval).
- The costs incurred by the entity generate or enhance resources the entity will use in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not a performance obligation in and of themselves, but do contribute to the satisfaction of the performance obligations).
- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the customer contract and expected renewals will cover the costs).

Costs incurred directly related to a contract include direct labor and materials, costs incurred only because the entity entered into the contract (e.g., subcontracting costs), costs allocable to the contract or contract activities (e.g., costs of contract management and supervision, insurance and depreciation of tools and equipment used in fulfilling the contract) and other costs explicitly chargeable to the customer under the contract.

Costs required to be expensed as incurred include general and administrative costs, unless explicitly chargeable or recoverable under the contract (e.g., contracts with the U.S. federal government through the provisions of the Federal Acquisition Regulations), costs related to satisfied or partially satisfied performance obligations (i.e., costs related to past performance), costs of wasted materials, labor or other resources to fulfill the contract that were not reflected in the contract price and costs that the entity cannot distinguish between unsatisfied, partially satisfied or satisfied performance obligations.

D.2 Incremental costs to obtain a customer contract

The incremental costs to obtain a specific customer contract within the scope of ASC 606 are those costs that would not have been incurred if the customer contract was not obtained. The incremental costs to obtain a customer contract should be capitalized if the entity expects to recover these costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). A common example of an incremental cost to obtain a contract is a sales commission.

An entity may elect a practical expedient that allows it to expense the incremental costs to obtain a customer contract if the amortization period for those costs would otherwise be one year or less. An entity is not allowed to defer costs simply for purposes of normalizing profit margins over the life of a contract.

The costs to obtain a customer contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the customer contract that would have been incurred even if the customer contract was not obtained. These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred. For example, costs such as salaries for employees working on a proposal likely would not be capitalized unless explicitly chargeable to the customer.

D.3 Amortization and impairment of capitalized costs

The amortization method and period used to amortize capitalized costs related to obtaining or fulfilling a customer contract (including an anticipated contract, such as a contract renewal) should be systematic and consistent with how and when the related goods or services are transferred to the customer.

Entities should use judgment to determine the amortization period. Depending on the facts and circumstances, it may be appropriate for a federal government contractor to use an amortization period longer than the initial contract period, such as periods related to contract renewals on a maintenance contract.

Costs capitalized in accordance with ASC 340-40 are tested for impairment by comparing the carrying amount of capitalized costs to an amount that considers all of the following: (a) the contract consideration an entity expects to receive in the future (b) the contract consideration the entity has already received but not yet recognized as revenue and (c) the direct costs related to transferring goods or services that remain to be recognized as an expense under the contract. For purposes of testing the capitalized costs for impairment, the time period reflected in the impairment test should take into consideration expected contract renewals and extensions with the same customer.

Once an impairment loss is recognized, it cannot be reversed under any circumstances.

E. Balance sheet presentation

Application of the guidance in ASC 606 may result in the recognition and presentation on the balance sheet of a contract asset or liability for the difference between a federal government contractor's performance (i.e., the goods or services transferred to the customer) and the customer's performance (i.e., the consideration paid by, or unconditionally due from, the customer). However, before recognizing a contract asset or liability, the entity must first consider whether an accounts receivable should be recognized.

As noted in paragraph 11.7.35 of the Revenue Recognition AAG, because the billing-to-performance relationship in long-term contracts is often complex, particularly with regard to work-in-progress subject to retentions, contracts with termination clauses, milestone payments that may not align with performance and revisions in estimates, understanding the relationship between revenue and changes in contract balances is critical to users of the financial statements and related qualitative and quantitative information should be disclosed. Proper balance sheet presentation provides transparency about revenues and cash flows in relation to current-period performance.

E.1 Accounts receivable

When determining the amount of the contract asset or liability to be recognized (if any), an entity should first determine whether it has an unconditional right to any consideration from the customer. An unconditional right exists when only the passage of time is required before customer payment. If the entity has an unconditional right to consideration from the customer, it should recognize a receivable. This is the case even if the customer has a right of refund or the amount has not been billed.

For example, as noted in paragraph 11.7.33 of the Revenue Recognition AAG, unbilled work-in-process related to a contract with a termination clause giving the contractor the right to payment (including related gross profit) for work performed to date if the customer terminates the contract would likely be reclassified from a contract asset to unbilled receivables.

Once recognized, a receivable is accounted for in accordance with the accounts receivable guidance in the ASC 310, "Receivables," and ASC 326-20, "Financial Instruments – Credit Losses – Measured at Amortized Cost" (once effective).

E.2 Contract assets and liabilities

A contract asset arises if the federal government contractor's performance is greater than that of the customer (i.e., the revenue recognized for the promised goods or services transferred to the customer is greater than the consideration paid or recognized as a receivable). The recognition of a contract asset signals to users of the financial statements that the entity has transferred promised goods or services to the customer (and recognized revenue) for which the customer has neither paid nor become unconditionally obligated to pay. In other words, a contract asset represents the entity's conditional right to consideration for its performance.

A contract liability arises if the customer's performance is greater than that of the federal government contractor (i.e., the consideration paid or recognized as a receivable is greater than the revenue recognized for the promised goods or services transferred to the customer). The contract liability is recognized upon the earlier of the customer making a payment or becoming unconditionally obligated to make a payment that results in the customer's performance being greater than the entity's performance. The recognition of a contract liability signals to users of the financial statements that the entity's customer has paid for, or is unconditionally obligated to pay for, promised goods or services the entity is obligated to transfer to the customer, but has not yet transferred to the customer. For example, a customer's upfront payment resulting in the customer's performance exceeding that of the federal government contractor would result in the entity recognizing a contract liability for its obligation to transfer goods or services under the contract.

Contract asset and *contract liability* are not required descriptors for the related asset or liability in the balance sheet. However, if a descriptor other than contract asset is used, it needs to clearly indicate that the asset represents something other than a receivable.

F. Disclosures

F.1 Disclosures required by ASC 606

The new guidance includes many new qualitative and quantitative disclosure requirements. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenues and related cash flows. In general, federal government contractors are required to disclose a variety of information about the contracts they have with customers and significant judgments used in applying the new guidance.

A federal government contractor should review its systems, processes, procedures and internal controls to determine whether it is capable of providing the information necessary to satisfy the new disclosure requirements discussed in the remainder of this section, and if not, what changes it must make to enable it to provide the necessary information.

F.1.1 Disaggregated revenue

Public companies are required to disclose a quantitative disaggregation of revenue based on how economic factors affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

Nonpublic companies that do not elect to provide the quantitative disclosures required for public federal government contractors should disaggregate revenue based on when control of the goods or services transfers to the customer (e.g., over time or at a point in time). In addition, such nonpublic federal government contractors should provide qualitative discussion about how economic factors (such as those that might otherwise serve as the basis for quantitative disaggregation) affect the nature, amount, timing and uncertainty of revenue recognition and cash flows.

When determining the appropriate disaggregation levels and categories to use in financial statement disclosures, public companies (and other companies that elect to provide the disclosures required of public companies) should consider how they present revenue for other purposes, such as to investors and members of management or governance committees. In considering the needs of financial statement users, a federal government contractor will want to carefully evaluate all sources of revenue and the varying judgments used to recognize different types of revenue. Common categories of disaggregated revenue include: (a) type of good or service (e.g., by major product line), (b) geographic region, (c) contract and customer type (e.g., fixed-price and time-and-materials contracts), (d) contract duration, (e) timing of transfer of goods or services (e.g., at a point in time or over time), or (f) market type (revenue from international or U.S. governments), among others.

F.1.2 Contract balances

All federal government contractors should disclose, or present separately on the face of the balance sheet, the opening and closing balances of accounts receivable, contract assets and contract liabilities.

Public federal government contractors are also required to disclose the following, which are optional for nonpublic federal government contractors:

- *The amount of revenue recognized in the current reporting period that was included in the contract liability balance at the end of the previous reporting period.* For example, if a federal government contractor had a contract liability balance at the end of the previous reporting period due to it receiving upfront nonrefundable payments for which it had not yet fully performed, it should disclose the amount of that liability that was recognized as revenue in the current reporting period.
- *An explanation (which may be qualitative) of the timing of the federal government contractor's satisfaction of its performance obligations compared to the timing of when it typically receives payment for providing the underlying goods or services and how the contract asset and contract liability balances are affected by this timing.*
- *A qualitative and quantitative explanation of what caused significant changes in the contract assets or contract liabilities during the reporting period.* For example, if a federal government contractor acquires another entity during the reporting period, it should explain the acquisition's effects on contract assets or contract liabilities.

A federal government contractor's revision of estimates (e.g., variable consideration, percentage of completion), if any, should be evaluated for its impact on contract balances. If material, an entity should explain the effects on contract assets or contract liabilities of revising an estimate. This will provide relevant information about the timing of revenue recognition that was not a result of current period performance.

F.1.3 Performance obligations

A federal government contractor is required to disclose the following about its performance obligations:

- When its performance obligations are typically satisfied
- Significant payment terms
- Nature of the promised goods or services provided to customers

- Obligations it has in its customer contracts related to rights of return or refund or other similar customer rights
- Warranties and related obligations
- Revenue recognized in the current reporting period related to performance obligations satisfied (or partially satisfied) in the prior reporting period

F.1.4 Transaction price allocated to remaining performance obligations

Remaining performance obligations are those performance obligations identified in a customer contract entered into before the end of a reporting period for which control of some or all of the underlying goods or services has not been transferred to the customer at the end of the reporting period. A remaining performance obligation may be a partially satisfied performance obligation or a completely unsatisfied performance obligation.

With certain exceptions, the following information about remaining performance obligations at the end of a reporting period should be disclosed by public federal government contractors and may be disclosed by nonpublic federal government contractors:

- *The total amount of the transaction price allocated to those performance obligations.*
- *An explanation of when the federal government contractor expects to recognize the transaction price allocated to these performance obligations as revenue.* This disclosure requirement can be satisfied either quantitatively (using appropriate time bands for when the allocated transaction price is expected to be recognized as revenue) or qualitatively.

As described further in ASC 606-10-50-14 to 50-14B, there are two optional exemptions related to these remaining performance obligation disclosure requirements. An entity should disclose which of the optional exemptions it has elected to apply, as well as the following information about the related remaining performance obligations: (a) their nature, (b) their remaining duration and (c) a description of any variable consideration excluded from the disclosures as a result of electing one or both of the optional exemptions.

F.1.5 Significant judgments

A federal government contractor should disclose judgments (and changes to those judgments) it makes in applying the new guidance that significantly affect when and how much revenue is recognized related to its customer contracts. The disclosures should include those judgments (and changes in judgments) involved in determining the transaction price, allocating the transaction price to performance obligations and determining when performance obligations are satisfied.

The following information should be disclosed by all federal government contractors:

- *For performance obligations satisfied over time, the specific input or output method used to recognize revenue.*
- *In applying the variable consideration constraint, the judgments involved in identifying the methods, inputs and assumptions used.*

The following additional information should be disclosed by public federal government contractors and may be disclosed by nonpublic federal government contractors:

- *For performance obligations satisfied over time, an explanation of why the specific input or output method used to recognize revenue over time provides a faithful depiction of how the federal government contractor transfers control of goods or services to its customers.* For example, if a federal government contractor recognizes revenue based on direct labor and materials costs incurred compared to budgeted costs, it should explain why that method is a faithful depiction of how it transfers goods or services.

- *For performance obligations satisfied at a point time, the significant judgments made in determining when control of the goods or services transfers to the federal government contractor's customers.*
- *The judgments involved in identifying the methods, inputs and assumptions used to determine and allocate the transaction price and measure any obligations related to the customer contract (e.g., returns, refunds), including (but not limited to) the following:*
 - If there is variable consideration, the federal government contractor should explain how it estimates the variable consideration (e.g., the most likely amount method or the expected value method).
 - If there is a significant financing component, such as certain long-term payment plans, the federal government contractor should disclose how it was reflected in the transaction price. Public federal government contractors electing the practical expedient that results in not reflecting a significant financing component in the transaction price (see Section C.3.1) should disclose that fact.
 - If there is noncash consideration, the federal government contractor should disclose how it was measured.
- *For contracts that include more than one performance obligation, the judgments involved in identifying the methods, inputs and assumptions used to: (a) estimate the standalone selling price of each performance obligation and (b) allocate any discount or variable consideration included in the contract.*
- *For rights of return or refund (e.g., right of refund related to some or all of an advance payment), the judgments involved in identifying the methods, inputs and assumptions used to estimate the related obligation.*

F.1.6 Contract costs

The following information related to costs incurred to obtain or fulfill a customer contract should be disclosed by public federal government contractors and may be disclosed by nonpublic federal government contractors:

- A description of the judgments made in identifying the costs that should be capitalized
- A description of the method used in each reporting period to amortize the capitalized costs and the amount of related amortization recognized for the reporting period
- The ending balances of capitalized costs by main category of asset (e.g., incremental costs to obtain a contract, setup costs)
- Any impairment loss recognized in the reporting period related to the capitalized costs
- If an entity elects the practical expedient allowing it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less, that fact (see Section D.2).

G. Transition

An entity may transition to the new guidance using either the full retrospective or modified retrospective method. For purposes of both transition methods, a completed contract is one for which all or substantially all of the revenue has already been recognized under legacy U.S. GAAP. In addition, the date of initial application is the beginning of the reporting period in which the new guidance is first applied by the entity. One or more practical expedients are available depending on the transition method selected.

The full retrospective transition method involves retrospective application to all periods presented. If an entity elects this method, it must provide the disclosures required for accounting changes in ASC 250, with certain exceptions, such as how the accounting change affects certain amounts in the current period income statement. This exception eliminates the need to determine the amounts that would have been reflected in the income statement if legacy GAAP had been applied in the current period.

The modified retrospective transition method involves application of the new guidance to either: (a) all contracts at the date of initial application or (b) only contracts that are not completed at the date of initial application. Prior periods are not adjusted to reflect application of the new guidance. Under this method, a cumulative effect adjustment is reflected in the opening balance of retained earnings as of the date of initial application (which is January 1, 2019 for a nonpublic federal government contractor with a calendar year end that adopts the new guidance as of the applicable effective date). If an entity elects the modified retrospective transition method, a variety of information must be disclosed, including the effects of applying the new guidance in the period of adoption. In other words, an entity must determine the amount of revenue and related costs it would have recognized in the period of adoption if it had continued to apply legacy GAAP in that period, disclose the change for each financial statement item affected and explain the reasons for those changes that are significant.

H. Conclusion

This white paper provides a discussion of the new revenue recognition and contract cost guidance, focusing on those areas most relevant to federal government contractors. For comprehensive discussion about the new guidance, including its scope, core principle and key steps, implementation guidance, presentation and disclosure requirements and effective date and transition provisions, refer to [A guide to revenue recognition](#).

All federal government contractors whose financial statements are prepared in accordance with U.S. GAAP will be affected by the new guidance because their accounting policies for revenue recognition will need to change to reflect the five-step revenue recognition model. In addition, every federal government contractor will be significantly affected by the disclosure requirements in the new guidance because they substantially increase the volume of revenue-related information disclosed in the financial statements, particularly for public federal government contractors. The new guidance will require federal government contractors to evaluate whether any changes are needed to their current revenue accounting and financial reporting processes, systems and procedures. This undoubtedly will require substantive involvement by more than just those involved in the accounting function.

We believe many middle-market federal government contractors will need to dedicate significant resources to properly assess and implement the changes brought about by ASC 606. Because compliance may be more challenging than many believe, federal government contractors should be well on their way to assessing how the new guidance will affect revenue recognition policies and disclosures, developing an implementation plan and completing that implementation plan. If you have questions about the new guidance or need implementation assistance, do not hesitate to contact your RSM representative or Mandy Wheat (+1 703 336 6357).

+1 800 274 3978
rsmus.com

This document contains general information, may be based on authorities that are subject to change, and is not a substitute for professional advice or services. This document does not constitute audit, tax, consulting, business, financial, investment, legal or other professional advice, and you should consult a qualified professional advisor before taking any action based on the information herein. RSM US LLP, its affiliates and related entities are not responsible for any loss resulting from or relating to reliance on this document by any person. Internal Revenue Service rules require us to inform you that this communication may be deemed a solicitation to provide tax services. This communication is being sent to individuals who have subscribed to receive it or who we believe would have an interest in the topics discussed.

RSM US LLP is a limited liability partnership and the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. The member firms of RSM International collaborate to provide services to global clients, but are separate and distinct legal entities that cannot obligate each other. Each member firm is responsible only for its own acts and omissions, and not those of any other party. Visit rsmus.com/aboutus for more information regarding RSM US LLP and RSM International.

RSM, the RSM logo and *the power of being understood* are registered trademarks of RSM International Association.

© 2019 RSM US LLP. All Rights Reserved.

