Financial Reporting Insights

REVENUE RECOGNITION FOR FEDERAL GOVERNMENT CONTRACTORS

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1. Introduction

In 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, to provide a robust framework and comprehensive principles for addressing revenue recognition issues. Additionally, the guidance on accounting for certain costs related to a contract with a customer in the scope of ASC 606 was codified in ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

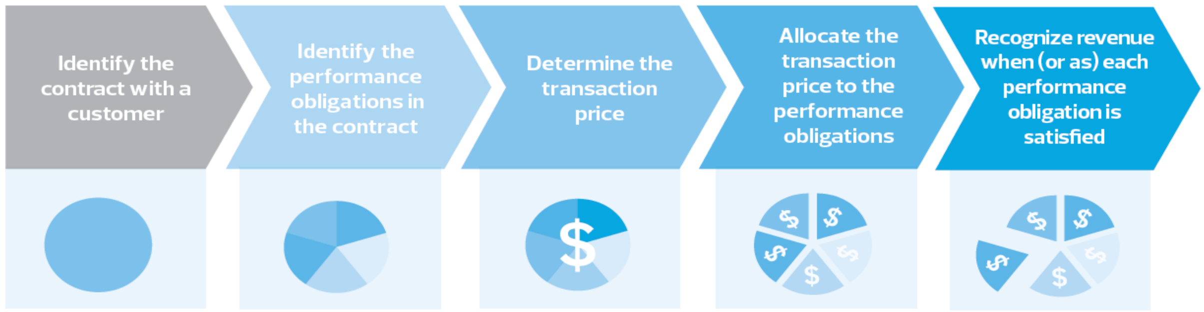
Following the release of ASC 606, the American Institute of Certified Public Accountants (AICPA) organized several industry-specific task forces to identify and provide guidance on revenue recognition implementation issues in specific industries. The culmination of the AICPA task forces' activities was the issuance in 2019 of a comprehensive nonauthoritative revenue recognition guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the guidance in ASC 606 to contracts in various industries. The Revenue Recognition AAG includes discussion of general accounting and auditing considerations related to ASC 606 and 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 3.1) and the evaluation of the unfunded portion of a contract (see Section 5.2.3).

For additional information about all of the revenue recognition guidance, including those aspects discussed in this white paper, as well as numerous examples illustrating how to apply the guidance, refer to our revenue recognition guide.

2. Core principle and key steps

To put the specific aspects of the revenue recognition guidance discussed in this white paper into proper context, it is important to know that the core principle included in the guidance (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." In addition, the guidance sets out the following steps for an entity to follow when applying the core principle to its revenue-generating transactions:



3. Step 1: Identifying 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." To account for a contract in accordance with the guidance, the following five contract existence criteria must be met:

- 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 very limited 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.

3.1 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 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. The length of this period may be affected by a number of factors, including whether the entity or its customer have termination rights under the contract.

Question 7 of FASB's Revenue Recognition Implementation Q&A highlights 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.

Contracts with the U.S. federal government ("government") are generally governed by the terms in the Federal Acquisition Regulations (FAR). FAR allows the government to terminate a contract at any point in time for convenience. Given the unusual nature of this type of termination clause outside of arrangements with the government, entities need to evaluate the impact of this clause on the contract term.

The legally enforceable contract period should be considered the contract term. Whether the legally enforceable contract period should include the period subject to an enforceable termination right depends on whether exercising that right results in a substantive termination penalty. Since the government can terminate a contract under FAR at any time for convenience, determining the term of the contract depends on whether this clause gives rise to a substantive termination penalty.

FAR Subpart 49.2 addresses the general principles for determining the settlement amounts for fixed-price contracts terminated for convenience. On termination of a contract for convenience by the government, FAR stipulates that the entity should be compensated fairly for both the work performed and preparations for the terminated portions of the contract. This would include compensation for the costs incurred on work performed and costs incurred for the terminated portions of the contract, including costs that may not otherwise have been incurred without termination, plus a reasonable profit allowance.

The significance of the expected settlement amounts based on FAR may vary depending on the specific goods or services being provided, which will impact the determination of whether a substantive termination penalty exists. This will need to be evaluated for each specific contract or contract type with the government. If a substantive termination penalty is deemed to exist, then the contract term will be the stated contract term without consideration of this termination right. Otherwise, since the contract can be cancelled by the government at any time, the contract term would be considered day to day.

3.2 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 contracts 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.

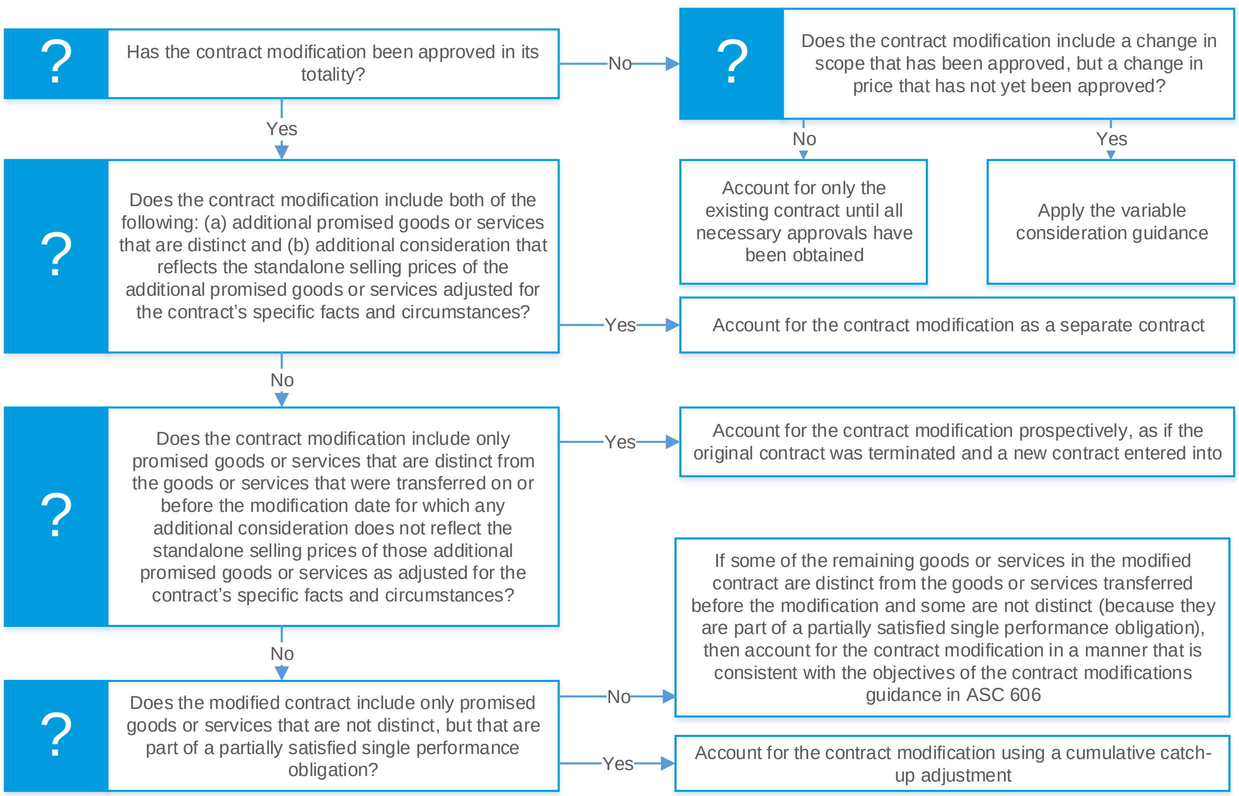
The requirement to combine contracts in certain situations for purposes of identifying a contract has no effect on an entity’s requirement to separate promises to transfer goods or services into performance obligations. If a promised good or service within a combined contract meets the criteria for being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

3.3 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 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 separate contract, the termination of one contract and execution of a new contract (prospective treatment) or an adjustment to the original contract (resulting in a cumulative catch-up adjustment).

The following chart walks through the application of the ASC 606 model to a contract modification:



Example 3-1: 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 four 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 two additional years for consideration of $300,000 payable in two equal annual installments of $150,000 at the beginning of years six and seven. The standalone selling price of the services for years six and seven 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 three years of IT support service. The entity recognizes revenue of $160,000 per year ($480,000 ÷ 3 years) as the services are provided over the remaining three years.

Example 3-2: Accounting for a disputed contract claim involving a change to the contract price (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 5.2.1) and include the estimate in the transaction price (subject to the variable consideration constraint discussed in Section 5.2.2).

4. Step 2: Identifying the performance obligations in the contract

After contract identification (Step 1), a federal government contractor needs to identify the performance obligations in the contract (Step 2). Identifying performance obligations in a contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized.

4.1 Identifying promises to transfer goods or services

The first step in identifying the performance obligations in the contract is to identify all promises to provide goods or services. Federal government contractors should scrutinize their contracts and identify all promises to transfer goods or services to the customer. Not all activities performed by the entity in connection with the 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 8.1).

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.

4.2 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 4.2.3).

4.2.1 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 from using, consuming, selling or otherwise holding the good or service for economic benefit either on its own or when combined with other readily available resources. For a resource to be readily available to a 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.

4.2.2 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 in the 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 in the 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 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 4-1: 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 obligations in a contract becomes clear when considering how accounting for a contract would differ if the entity reached an improper conclusion about identified performance obligations. In Example 4-1, 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 Chapter 6) 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.

4.2.3 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 each of the goods or services otherwise being considered satisfied over time (see Section 7.1) and the entity otherwise having to use the same method of measuring progress toward completion for each of the goods or services (see Section 7.1.3). 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.

5. Step 3: Determining the transaction price

5.1 General requirements for determining the transaction price

Transaction price 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, ASC 606 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 entity’s transfer of the promised goods or services to the customer and customer payment for those goods or services to be one year or less at contract inception.

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.

5.2 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 amount of 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) 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).

There are certain scenarios in which an entity may not be required to estimate variable consideration:

- An entity provides a series of distinct good or services for which the variable payments relate specifically to the entity's efforts to transfer each distinct good or service within the series (see Section 8.3.2.1 5 of our revenue recognition guide)
- An entity is entitled to sales- or usage-based royalties and the only, or predominant, item to which the royalty relates is the license of IP (see Section 7.3.5 of our revenue recognition guide)
- An entity elects to apply the practical expedient that allows revenue to be recognized for the amount the entity has a right to invoice (see Section 9.3.1.1 of our revenue recognition guide)

Outside of these exceptions, an estimate of the variable consideration to which an entity expects to be entitled should be included in the transaction price to the extent it is probable that its inclusion will not result in a significant reversal of cumulative revenue recognized when the uncertainty giving rise to the variability is resolved. This approach to determining the amount of variable consideration that an entity should include in the transaction price suggests the following two steps should be performed:

1. Estimate the amount of variable consideration to which the entity expects to be entitled using either the expected value method or the most likely amount method (see Section 5.2.1).

2. Constrain the estimated 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 5.2.2).

While these appear to be two discrete steps, an entity's use of the expected value method to estimate the variable consideration to which it expects to be entitled may reduce, depending on the facts and circumstances, the probability of a revenue reversal such that the entity does not have to separately constrain its estimate of variable consideration (see Question 7Q.3.3.1 of our revenue recognition guide).

5.2.1 Estimating variable consideration

The most likely amount method or the expected value method must be used to estimate the variable consideration to which the entity expects to be entitled. 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% 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 5.2.2.

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 5-1: 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% of the agency's annual budget in exchange for a fixed fee of $200,000. To incentivize Company A to identify additional cost savings, the government agrees to pay Company A up to an additional 8% 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 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 5.2.2) 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.

5.2.2 Applying the 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 reversal of cumulative revenue recognized for the contract that is significant as compared to the transaction price, including both fixed and variable consideration, 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.

Question 30 of FASB's Revenue Recognition Implementation Q&A discusses whether the constraint on variable consideration should be applied at the contract level or the performance obligation level 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.

As noted in Section 5.2, 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.

Questions to consider (depending on their likelihood and magnitude) 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 the 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 answers to many of these questions 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.

5.2.3 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:

- Whether there is a short period of time before contract funding is expected
- Whether the work is sole source, a follow-on effort, or there is high competition
- Whether customer funding and budget exist and the task of processing the funding is administrative only

- Whether it is a major program or the customer is in critical need of the program
- Whether there has been communication from the customer that funding will be obtained
- 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 5-2: Evaluating unfunded portions of a contract (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 be needed 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.

6. Step 4: Allocating the transaction price to the performance obligations

If a 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 or variable consideration that can be shown (by meeting certain criteria) to be related to one or more (but fewer than all) performance obligations. In addition, a 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 obligations 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 the total transaction price and 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).

7. Step 5: Recognizing 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 at contract inception an evaluation 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 the customer 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 assets included in other performance obligations in the contract for which control transfer will be separately evaluated.

7.1 Determining 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 the customer receives those benefits and 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 criterion 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 this Chapter 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 land owned by the customer.
- *No alternative use and an enforceable right to payment for performance to date.* A performance obligation is satisfied over time if the asset created by the entity's performance does not have an alternative use to the entity upon its completion (see Section 7.1.1) and the entity's right to payment for its performance to date is enforceable (see Section 7.1.2).

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 criteria to determine whether revenue should be recognized over time or at a point in time.

If the performance obligation is considered satisfied over time because one of the criteria discussed earlier is met, 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.

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.

7.1.1 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 incurring significant costs to rework an asset because it was built to the original customer's specifications or 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, when assessing whether it could redirect the asset for another use, the entity does not consider the possibility that the contract could be terminated.

Example 7-1: Determining whether a satellite has an alternative use to the entity (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.

7.1.2 Enforceable right to payment for performance to date

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, an entity is not necessarily required to conclude that it has a present unconditional right to payment and the amount to which the entity is entitled does not have to be a fixed amount.

To draw an appropriate conclusion with respect to whether the entity has an enforceable right to payment (by either demanding 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 previously noted, contracts with the government are generally governed by the terms in the FAR, which allows the government to terminate a contract at any point in time for convenience. FAR Subpart 49.2 addresses the general principles for determining the settlement amounts for fixed-price contracts terminated for convenience. On termination of a contract for convenience by the government, FAR stipulates that the entity should be compensated fairly for both the work performed and preparations for the terminated portions of the contract. This would include compensation for the costs incurred on work performed and costs incurred for the terminated portions of the contract, including costs that may not otherwise have been incurred without termination, plus a reasonable profit allowance.

We believe the termination for convenience clause and related settlement provision of FAR support that an enforceable right to payment for performance to date exists as the entity is entitled to proportionate compensation for its performance to date at all times during the contract if the contract were terminated by the government for reasons other than the entity not performing as promised. In these situations, an entity would still be required to evaluate whether an asset has no alternative use as discussed in Section 7.1.1 to determine whether revenue can be recognized over time.

Example 7-2: 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.

7.1.3 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*.

7.1.3.1 Output methods

Output methods rely on the value of the 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. (However, as discussed in the next paragraph, care should be exercised in selecting and applying this method.)
- 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. (However, as discussed in the next paragraph, care should be exercised in selecting and applying this method.)

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 method takes into consideration any work in process at the beginning of the reporting period for which control transferred to the customer in the previous reporting period and any work in process at the end of the reporting period for which control transferred to the customer in the current reporting period. If the units-produced or units-delivered method does not appropriately consider work in process for which control has transferred to the customer at the end of a reporting period, it should not be used to measure the entity's revenue. 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 contract requires the entity to provide operations and maintenance services to a customer over a period of time, and the customer is obligated to pay the same hourly rate regardless of the nature or timing of the services provided, the entity may be able to elect this practical expedient. If the practical expedient is elected, the entity does not determine or allocate the transaction price. 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.

7.1.3.2 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 adjust 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 7-3: Applying a cost-to-cost input method to a services contract with a change in the estimate of total costs

Company A enters into a contract with Customer B, a veteran affairs nursing home, on Sept. 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 Dec. 31, 20X1 (its calendar year end), Company A has incurred costs of $8.5 million, received the September 1 payment of $7 million from Customer B and 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 Sept. 1, 20X1 to Dec. 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 would also be affected as Company A incurred the $8.5 million of costs, including cash (e.g., payments for labor costs).

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 incurred total costs to date of $16,660,000, received the Dec. 1, 20X1 payment of $7 million from Customer B and 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)	2,149,000	
Revenue (Note 3)		$9,149,000
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 $1,851,000 at March 31, 20X2 because it represents the difference between Customer B's performance and obligation to perform of $21 million (which is three payments paid or payable of $7 million) and Company A's performance of $19,149,000 ($10 million of revenue recognized in 20X1 + $9,149,000 of revenue recognized thus far in 20X2 [Note 3]). The balance in the contract liability was $4 million at Dec. 31, 20X1. As a result, the balance in the contract liability should be reduced by $2,149,000.

Note 3: ($100,000,000 transaction price × [($16,660,000 total costs incurred) ÷ ($87 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.

7.2 Loss provisions

ASC 605-35 provides guidance 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 contractor may be a prime contractor or a subcontractor and 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 ASC 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 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. 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.	From ASC 605-35-15-6: a. Sales by a manufacturer of goods produced in a standard manufacturing operation, even 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. 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

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

7.2.1 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 3.2). 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.

7.2.2 Current estimate of contract costs

The current estimate of contract costs should include all of the fulfillment costs allocable to a contract. For its cost-plus contracts, a federal government contractor also should consider whether any nonreimbursable costs should be included in the current estimate of contract costs. For all its contracts, the contractor should consider whether there are any costs associated with change orders accounted for as contract modifications (see Section 3.3) 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.

7.2.3 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 its credit risk and increased by the effects of removing the variable consideration constraint (if any) (see Section 5.2.2).
- *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 Chapter 6), which results in the current estimate of consideration expected to be received for each performance obligation.

7.2.4 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 presented as a reduction of revenue or 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.

8. Contract costs

8.1 Scope

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

8.2 Costs to fulfill a contract

If there is other guidance in the ASC that applies to the costs incurred to fulfill a contract within the scope of ASC 606, that other guidance should be applied. Examples of other guidance on how to account for costs that may be involved in the fulfillment of a contract are listed in the following table:

ASC	Type of fulfillment cost
330	Inventory
340-10-25-1 to 25-4	Preproduction costs related to long-term supply contracts
350-40	Costs of internal-use software
360	Costs related to property, plant and equipment
720-35-25-1A	Certain advertising expenditures incurred after revenue is recognized (e.g., cooperative advertising)
946-720-25-3	Offering costs of advisors of both public and private funds

ASC	Type of fulfillment cost
985-20	Costs of software to be sold, leased or marketed

Note 1: Prior to applying the guidance noted, it is important to understand the specific scope provisions of the guidance to ensure it is applicable to an entity and the specific cost being evaluated.

If the guidance in the table or other specific guidance is applicable to a fulfillment cost incurred by the entity, it must be applied. ASC 340-40 is only applicable to costs to fulfill a contract when there is no other applicable guidance. Costs to fulfill a 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 that will be used in the future to satisfy (or continue to satisfy) its performance obligations (i.e., the activities giving rise to the costs are not performance obligations in and of themselves, but do contribute to the satisfaction of performance obligations).
- The costs incurred by the entity are expected to be recovered (i.e., the net cash flows of the 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 government through the provisions of FAR), 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.

8.3 Costs to obtain a contract

The incremental costs to obtain a specific contract within the scope of ASC 606 are those costs that would not have been incurred if the contract was not obtained, such as a sales commission. For a cost to be considered an incremental cost of obtaining a contract, the insurance entity must be obligated to make a payment only as a result of entering into the contract. The incremental costs to obtain a contract should be capitalized if the insurance entity expects to recover those costs (i.e., the net cash flows of the contract and expected renewals will cover the costs). However, an insurance entity may elect a practical expedient that allows it to expense the incremental costs to obtain a contract if the amortization period for those costs would otherwise be one year or less.

Costs to obtain a contract within the scope of ASC 606 that are not incremental are those costs related to obtaining the contract that would have been incurred even if the contract was not obtained (e.g., travel costs incurred to present a proposal to the customer). These costs should only be capitalized if they are explicitly chargeable to the customer regardless of whether the insurance entity enters into a contract with the customer. Otherwise, such costs are expensed as incurred.

8.4 Amortization and impairment of capitalized costs

The amortization method and period used to amortize capitalized costs related to obtaining or fulfilling a 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 the contract consideration an entity expects to receive in the future, the contract consideration the entity has already received but not yet recognized as revenue and 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.

9. 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.

9.1 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.

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*.

9.2 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.

Typically, a refund liability to the customer (which may arise, for example, when the customer has the right of return) should not be included with the contract liability for presentation purposes.

10. Disclosures

Many qualitative and quantitative disclosure requirements are included in ASC 606-10-50 and ASC 340-40-50. ASC 606-10-50-1 states the following as the overall disclosure objective of ASC 606 (which is also the overall disclosure objective of ASC 340-40): "The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers."

The disclosures required to achieve this objective focus on providing a variety of revenue-related information. Some of the information that must be disclosed is high-level, such as the amount of revenue recognized from customer contracts and the amount of any impairment (or credit) losses recognized on receivables or contract assets related to customer contracts. However, there is also a significant amount of detailed information that must be disclosed annually related to customer contracts, including information about:

- Disaggregated revenue
- Contract assets, contract liabilities and receivables
- Performance obligations
- Transaction price allocated to remaining performance obligations at the end of the reporting period (disclosures required for public entities and elective for nonpublic entities)
- Significant judgments about the timing of satisfying performance obligations

- Significant judgments about the transaction price and the amounts allocated to performance obligations
- Practical expedients (disclosures required for public entities and elective for nonpublic entities)
- Capitalized costs related to obtaining or fulfilling a customer contract (disclosures required for public entities and elective for nonpublic entities)

The nature and extent of the required disclosures in each of the preceding categories depends on whether the federal government contractor is a public entity (more required disclosures) or nonpublic entity (fewer required disclosures). In addition, while more disclosures are required for annual periods, some disclosures also are required of public entities for interim periods. However, when a federal government contractor applies ASC 606 and 340-40 in its interim financial statements for one or more interim periods before it applies ASC 606 and 340-40 in its annual financial statements, the entity must provide all the required annual disclosures in those interim financial statements.

Detailed discussion and illustrations of the disclosure requirements for both public and nonpublic entities are included in Chapter 15 of our revenue recognition guide.

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