How Government Contractors Can Apply the Five-Step Revenue Recognition Model

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Privately held government contractors racing to implement new FASB and IASB standards for identifying and reporting revenue from customer contracts by the end of this year are wrestling with one overarching question–when?

When does a contract meet the criteria for existence? When should we consider a good or service distinct under the new standards? When do we recognize revenue over the course of a multi-year contract with numerous performance obligations and budget variables? The following five-step model for complying with the customer contracts standards answers these questions and more:

THE FIVE-STEP MODEL

Step 1. Identify the contract.
Step 2. Identify the separate performance obligations.
Step 3. Determine the transaction price.
Step 4. Allocate the transaction price to performance obligations.
Step 5. Recognize revenue once the performance obligation has been satisfied.

Background

By now, most government contractors know general information about the new FASB and IASB standards for recording revenue from customer contracts, like when the standard goes into effect. The effective date for public entities applied to the first interim period for annual reporting periods beginning after December 15, 2017. All nonpublic entities, including nonpublic government contracting companies, must adopt ASC 606 or IFRS 15 in the annual reporting period beginning after December 15, 2018.

For a refresher on the main provisions of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), refer to our Spring 2017 Newsletter. In our last issue, the Spring 2018 Newsletter, we reviewed the steps for implementation and issues specific to government contractors that may arise.

Step 1. Identify the Contract

The first step in this process is to identify when a contract is created between a government contractor and its customer. Government contracts, especially those subject to Federal Acquisitions Regulations (FAR), must meet all the following five criteria:

1. Both parties must approve and sign the agreement;

2. Both parties must identify their rights regarding goods and services to be transferred, often using standard forms and clauses required under FAR;
3. Standard payment terms for goods and services to be transferred are identified;
4. The contract has commercial substance where the risk, timing or amount of the goods or services to be transferred can be identified; and
5. Collectability of consideration is probable, meaning the customer has the ability and intention to pay amounts when they become due.

This last factor is important for government contractors who enter into unfunded or partially-funded contracts. Approved enforceable contracts with the U.S. government meet the criteria for contract existence–for both funded and unfunded portions–as federal contracts have a low likelihood of cancellation and demonstrate a commitment to pay. Once the contract is deemed to exist, the unfunded portion is considered variable consideration (similar to award or incentive fees). The contractor includes variable consideration in the transaction price when it is probable that a significant reversal of cumulative revenue will not occur when the uncertainty (the unfunded portion) is resolved.

Termination clauses also take on new meaning and importance under the new revenue standards. As "termination for convenience" clauses are typically required by FAR for contracts with the U.S. federal government and require compensation to the vendor for work performed through termination, these clauses support the concept that the contract has commercial substance. Therefore, the entity would not assume cancellation in determining the scope and term of the contract, as well as the transaction price.

Step 2. Identify the Separate Performance Obligations

A performance obligation is a promise to transfer a distinct good or service, or a series of goods or services that are substantially the same and that have the same pattern of transfer, to the customer. In this step, the government contractor must specify performance obligations and when they will be performed, whether on or by a specific date or over time. Parties must identify the unit of account for each good or service and assign a transaction price to the fulfillment of those performance obligations.

Step 3. Determine the Transaction Price

The transaction price, or the amount of consideration that a government contractor expects in exchange for transferring promised goods or services to a customer, can vary depending on the nature of the performance obligations and timing. Timing considerations come into play here because the new ASC 606 standards require entities to estimate variable consideration when determining the transaction price, even if the promised consideration is based upon the occurrence or nonoccurrence of a future event. Examples of variable consideration include discounts, rebates, refunds, credits, award fees, incentive fees, performance bonuses or penalties, and contingencies based on the occurrence or non-occurrence of a future event, such as financing or funding.

The requirement to estimate variable consideration represents a significant change to U.S. GAAP. Under the new standard, there is no "fixed or determinable" concept. This change reflects the new standard's principle that revenue should more closely depict the transfer of control. That is, the

standard accepts more uncertainty in the measurement of revenue compared to prior U.S. GAAP to more closely reflect a vendor's performance.

Step 4. Allocate the Transaction Price to Performance Obligations

In this step, the government contractor allocates or divides the transaction price, as determined in Step 3, between its performance obligations, which were identified in Step 2. The allocation is based on the relative "standalone selling price" of each identified performance obligation, being the price at which the entity would sell a promised good or service separately to a customer. If there is an observable price of a good or service when the entity sells that good or service, that is the price that would be used. If not, the entity must estimate the standalone selling price, maximizing the use of observable inputs, and considering all available information.

There are three methods prescribed in Step 4 to determine standalone selling price (i) adjusted market approach, (ii) expected cost plus margin approach, (iii) residual approach. Unless the entity or a competitor has sold a standard product or service for a period of time that it can use as the basis for its analysis, the expected cost plus margin approach will often be the best estimation method for a contract with the U.S. federal government.

Step 5. Recognize Revenue Once the Performance Obligation has Been Satisfied

The core principle of the new FASB and IASB revenue reporting standards is that companies must recognize revenue when control of goods or services are transferred to customers in an amount that reflects the consideration to which the entity expects to be entitled for those goods or services. To comply with this core requirement, a government contractor must decide whether a performance obligation will be satisfied over time, or at a point in time. Revenue should be recognized over time if one of three criteria are met:

- The customer simultaneously receives and consumes all of the economic benefits provided by the entity's performance
- The entity creates or enhances an asset controlled by the customer
- The entity's performance does not create an asset for which the entity has an alternative use AND the entity has an enforceable right to payment for performance completed to date

Government contractors can determine whether the control of goods or services has been transferred to the customer. Some indications that the control has transferred might include:

- The contractor earns the right to payment;
- The customer takes legal title to an asset;
- The contractor transfers physical possession of an asset to the customer;
- The customer assumes any significant risks and rewards of ownership of an asset; or
- The customer accepts the asset.

Satisfaction of one or more of the above criteria may demonstrate that the performance obligation has been satisfied.

Consult Your Auditor

When you find yourself having more questions than answers about the new standards for reporting revenue from customer contracts, an auditor can provide information, updates and reminders about the Topic 606 changes to make sure you are prepared to meet the December 2018 deadline.

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