BDO USA

Home < Insights < Assurance

ARTICLE

February 20, 2024

BY:

William Laubach
Director, Government Contract Assurance

David Libbares
Principal, Government Contract Assurance

Revenue Recognition Under ASC 606: Best Practices for Government Contractors

When Accounting Standards Codification Topic 606 (ASC 606), *Revenue from Contracts with Customers*, took effect in 2019 for private companies, many government contractors lacked clarity on the new standard and struggled to understand how the requirements applied to their contracts — even after subsequent guidance from the FASB.

Following implementation, BDO has identified best practices and processes for navigating complexity that can help resolve potential questions or issues and avoid errors. We advise government contractors on how to apply the principle consistently in their accounting and reporting practices.

Read on for our breakdown of ASC 606's five-step model and the key considerations government contractors need to know. We examine the five steps and highlight some key risks for each, as well as contrasts with previous U.S. GAAP measures and other potential issues.

ASC 606 Five-Step Model

1. Identify the Contract With the Customer
2. Identify Separate Performance Obligations
3. Determine Transaction Price
4. Allocate Transaction Price to the Performance Obligations
5. Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

Step 1: Identify the Contract With the Customer

The criteria for contract existence are typically met with a standard government contract. Contracts can be written, oral or implied by the entity's business practices.

Contracts with customers must meet ALL the following criteria:

- The contract has approval and commitment from both parties.
- Each party's rights regarding good and services to be transferred are identified.
- The payment terms for goods and services to be transferred are identified.
- The contract has commercial substance.
- Collectability of consideration is probable.

Be aware that additional guidance applies relating to combining contracts, contract modifications, unfunded contracts and indefinite delivery/indefinite quantity (IDIQ) contracts or master service agreements (MSAs).

Contrast to previous U.S. GAAP: Before ASC 606, guidance did not exist for combining (and segmenting) contracts outside the scope of construction-type/production-type contracts. ASC 606 clarifies the basis for this determination for all entities and all types of contracts (e.g., services-based or production-based contracts).

Key Risks

- Inconsistent treatment of contracts with similar attributes.
- Contracts with the same customer are accounted for inappropriately as combined or separate contracts.
- Contract modifications are accounted for incorrectly.
- Commercial contracts.
- Contracts that are not part of the entity's normal terms and conditions.
- Unfunded portions of U.S. federal government contracts.

Step 2: Identify Separate Performance Obligations

In simple terms, a vendor must identify what their contractual deliverables are to their customers. The company will identify each of its performance obligations in a contract, which then serves as the basis to allocate the transaction price to the performance obligations and recognize revenue.

A performance obligation is a promise to a customer to transfer either of the following:

- A good or service (or bundle of goods or services) that is distinct (e.g., product, training, and maintenance); or

- A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer (e.g., satisfied “over time” for each distinct good or service).

A good or service is distinct if both of the following two criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer; and
- The promise to transfer a good or service is separately identifiable from other promises in the contract.

Consideration must be made for both the explicit and the implicit promises in the contract. Notable for government contracting organizations are customer options, which are typically related to the opportunity to purchase additional good and services and renewal periods with different option years. In many cases, customer options are considered a separate performance obligation when they provide a material right to the customer that the customer would not have received without entering into the original contract.

Key Risks

- Performance obligations are not appropriately identified.
- Bundled promises are not distinct within the context of the contract.

Step 3: Determine Transaction Price

The transaction price is the amount of the consideration to which an entity expects to be entitled to in exchange for transferring the promised goods or services. The transaction price may include an element of consideration that is variable or contingent based on the future outcomes. Variable consideration can arise due to:

- Discounts, rebates, refunds and credits.

- Award fees, incentive fees and performance bonuses.
- Claims, cost/performance incentives or penalties.
- Consideration contingent on the occurrence/non-occurrence of a future event (funding).

When a contract contains variable consideration, the transaction price is estimated. In these cases, there are two methods used to determine the transaction price: the expected value method and the most likely amount method. The expected value method is the sum of the probability-weighted amounts for a range of possible outcomes. This method is most appropriate where there are a larger number of contracts with similar characteristics or if a contract has a large number of possible outcomes. In the most likely amount method, the single most likely amount out of a possible range of outcomes is utilized, and this method is most appropriate where there are only two possible outcomes.

Contrast to previous U.S. GAAP: ASC 605-10-S99 (SAB 104) had required the seller's price to the buyer be fixed or determinable as one criteria for revenue recognition. Under ASC 606, revenue recognition may occur before the price is fixed or determinable because variable/contingent payments to be received in future are estimated for revenue recognition.

Key Risks

- Variable consideration is subject to management's estimate and may be subject to bias, including risk of management override of controls and risk of fraud.
- Must obtain audit evidence indicating whether there may have been any change in amount of consideration received when entity reassesses estimates of variable consideration.
- Consider constraints related to variable consideration and how management has assessed the probability of significant reversal of revenues.
- Consider reliability and auditability of underlying information used in estimates.

Step 4: Allocate Transaction Price to Performance Obligations

To determine the standalone selling price of a performance obligation, answer the following question: Is there an observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers?

- If “Yes,” then use that price.
- If “No,” then estimate the price, maximizing the use of observable inputs and considering all available information (i.e., market conditions, customers, entity-specific value).

There are three main methods for estimating the standalone selling price:

- Adjusted market approach
  - Estimate the price customers in the market would be willing to pay.
  - Consider competitors’ prices for similar goods and services.
- Expected cost plus margin approach
  - Forecast the expected costs and then add an appropriate margin.
- Residual approach
  - Total transaction price less the observable standalone selling prices of other performance obligations.
  - However, use of this approach is restricted to:
    - Those goods or services for which there is a wide range of selling prices; or
    - Circumstances in which the selling price is uncertain because no selling price has been set for the good or service and it has not previously been sold on a standalone basis.
  - This approach can only be used after the allocation of any discounts.

Government contractors typically utilize the expected cost plus margin approach as it aligns with the process to bid and propose on new government contracts, as well as the cost accounting requirements under the Federal Acquisition Regulations (FAR) and Cost Accounting Standards

(CAS).

Contrast to previous U.S. GAAP: Use of the residual method previously allocated the entire discount to the delivered item. In contrast, a residual approach under ASC 606 is used to estimate the standalone selling price, not to actually allocate consideration to a performance obligation.

Key Risks

- A contractually stated price or a list price is presumed to be the standalone selling price without appropriate analysis.
- Discounts and/or variable consideration are not allocated appropriately to performance obligations.
- Inconsistent approach used by management to allocate transaction price to similar revenue transactions.

Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation

The principle of revenue recognition has moved from a "transfer of risks and rewards" to "the transfer of control of the goods or services to the customer."

The transfer of risks and rewards is now simply an indicator for revenue recognition. A performance obligation (e.g., service, product, maintenance) is satisfied and revenue is recognized when "control" of the promised good or service is transferred to the customer. "Control" in the context of ASC 606 is defined as the ability to direct the use of an asset and obtain substantially all of the remaining benefits from that asset. Indicators that control has passed include that the customer has: a present obligation to pay, physical possession, legal title, risk/rewards of ownership and has accepted the asset.

Revenue is recognized either:

- Over time (subject to various criteria under ASC 606 referred to below).

- At a point in time (if the criteria for recognition over time under ASC 606 are not met).

The two approaches are mutually exclusive, assessed for each performance obligation and determined at contract inception.

Recognize revenue over time if one of the following three criteria are met:

1. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
2. The entity creates or enhances an asset controlled by the customer.
3. 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.

Measuring Progress Toward Complete Satisfaction of a Performance Obligation

In measuring progress toward satisfaction of a performance obligation, it's helpful to remember the concept that the focus should be based on an entity's performance in transferring control of goods or services promised to a customer (ASC 606-10-25-31).

For each performance obligation that is satisfied over time, revenue is recognized by measuring progress toward completion of that performance obligation in each reporting period. This is achieved based on either:

- Input methods: costs incurred, resources consumed, labor hours expended, time lapsed or machine hours used; or
- Output methods: appraisals of results, substantive milestones reached, units produced, and units delivered.

For many cost reimbursable contracts and other government contracts, the input method using cost incurred is commonly used.

For each separate performance obligation, the same method of assessing progress to date is required to be used. The same method is also required to be applied consistently to similar performance obligations and in similar circumstances.

One commonly adopted guidance is the right to invoice practical expedient. This expedient allows that if an entity has a right to consideration from a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity may recognize revenue in the amount to which the entity has the right to invoice.

If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time. Indicators to be considered when determining whether control has been transferred to the customer include:

1. Does the entity have a present right to payment for the asset?
2. Does the customer have legal title to the asset?
3. Does the customer have physical possession of the asset?
4. Have the significant risks and rewards of ownership been transferred?
5. Has there been acceptance of the asset by the customer?

Key Risks

- Improper documentation of evidential support that transfer of control is occurring over a period of time.
- Management defaults to a method of revenue recognition that does not accurately reflect how control of a good or service transfers to the customer.
- Management does not accurately measure progress toward completion.

Other Considerations

Principal vs. Agent

Under previous guidance, it was sometimes difficult to determine whether a party is acting as a principal or an agent. This area remains challenging under ASC 606 and continues to require significant judgment.

Indicators of a principal relationship include, but are not limited to:

- The entity is primarily responsible for fulfilling the promise to the specified good or service.
- The entity has inventory risk before the specified good or service has been transferred to a customer, or after transfer of control to the customer (i.e., the customer has a right of return).
- The entity has discretion in establishing the prices for the specified goods or services.

Alternatively, an entity is an agent and records revenue on a net basis if its role is only to arrange for another entity (i.e., the principal) to provide that good or service to the customer.

Principal versus agent considerations are prominent in the government contracting industry through Contractor Team Arrangements (CTAs) and Value-Added Resellers (VARs) among other relationships.

There is no one size fits all answer in this matter - significant focus must be placed on precise terms of the contract in reaching a conclusion.

Contract Costs

Incremental Costs of Obtaining a Contract

An entity is required to capitalize incremental costs on a contract (e.g., sales commissions) if those costs are only incurred as a result of obtaining a contract and the entity expects to recover them. Costs that will be incurred regardless of whether the contract is obtained – including costs that are incremental to trying to gain a contract, such as bid and proposal costs that are incurred even if the entity does not obtain the contract – are expensed as they are incurred.

Practical expedient: an entity is not required to capitalize the incremental costs to obtain a contract if the amortization period for the asset would be one year or less.

Costs to Fulfill a Contract

Often entities incur pre-contract costs or carry out activities before a contract exists (such as engineering, design, production materials, and costs incurred to acquire or produce goods in excess of contractual requirements) to meet forecasted or anticipated demand from customers.

If the pre-contract costs and other costs incurred in fulfilling a contract (or anticipated contract) with a customer are outside the scope of other guidance (e.g., inventory, intangibles, R&D, or fixed assets), then an entity recognizes an asset only if the costs (i) relate directly to an existing contract or specific anticipated contract, (ii) generate or enhance resources of the entity that will be used to satisfy performance obligations in the future, and (iii) are expected to be recovered.

If the costs to fulfill a contract are within the scope of another standard, then those costs shall be recognized in accordance with that standard.

Contract costs related to obtaining or fulfilling a contract that are recorded as an asset should be amortized on a systematic basis consistent with the transfer to the customer of the goods / services to which the asset relates, as well as be evaluated for impairment.

Key Risks

- Costs are inappropriately capitalized or recognized as an expense.
- Incremental costs of obtaining a contract are inappropriately expensed as incurred when period of benefit is greater than 12 months.
- Assets recognized for contract costs are impaired.

There are additional focus areas that may require further consideration, including:

- Unfunded portions of U.S. federal government contracts.
- Customer termination rights.
- Discounted option years.
- Assets with an alternative use.
- Estimates towards completion of a performance obligation.
- Non-U.S. government contracts vs. assets produced under U.S. government contracts.

The experienced professionals in BDO's Government Contracting practice can help you understand the complexities and best practices related to ASC 606. For additional insights on this topic, you can also access our related webinar, ASC 606 Revenue Recognition–Technical Considerations for Government Contractors. Additional guidance can be found by downloading BDO's Revenue Recognition Blueprint, which includes practical examples and interpretive guidance on ASC 606 and helps organizations understand and continue to comply with the revenue standard as business models, service lines, and pricing practices change.

Key Risks

- Costs are inappropriately capitalized or recognized as an expense.
- Incremental costs of obtaining a contract are inappropriately expensed as incurred when period of benefit is greater than 12 months.
- Assets recognized for contract costs are impaired.

Have Questions? Contact Us