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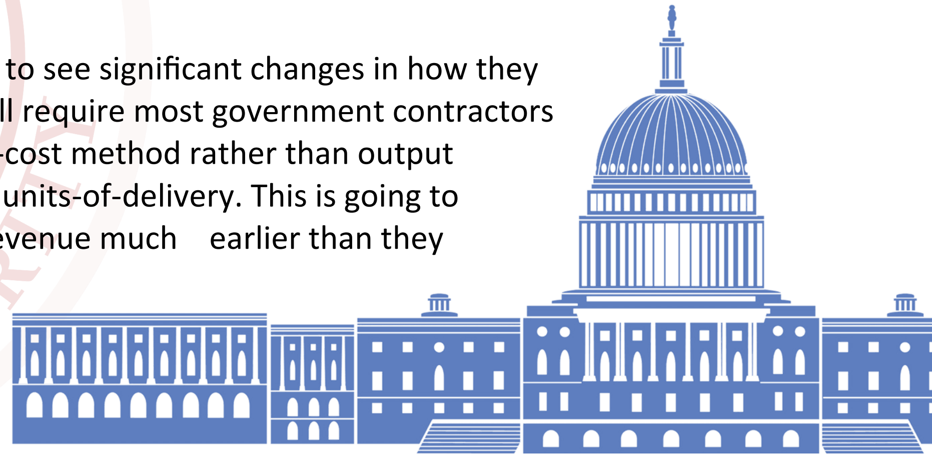
INDUSTRY OF IMPACT:

GOVERNMENT CONTRACTOR

Many government contractors are going to see significant changes in how they recognize revenue. The new standard will require most government contractors use an input method such as the cost-to-cost method rather than output methods, such as units-of-production or units-of-delivery. This is going to result in many contractors recognizing revenue much earlier than they had in the past.



The following are special considerations for the government contractor industry:

Unfunded Portion of Contracts

Certain long-term contracts with governments may only be partially funded at the onset due to normal budget cycles. Government contractors must now assess the likelihood of contract cancellation for these types of contracts. If the contractor believes that there is only a remote possibility of cancellation then the contract can be considered non-cancellable.

Contract Term

Government contractors with contracts that contain termination clauses, such as termination for convenience clauses, must now assess whether the termination clause affects the enforceability of the rights and obligations in the contract in determining the term of the contract. This would impact the measurement and allocation of the transaction price.

Pre-Contract Activities

Incremental costs of obtaining a contract are capitalized if they relate to a specific contract (e.g. sales commission), have future benefit (e.g. drawings) and are expected to be recovered. They are amortized to expense over the same basis as revenue is recognized.

Contract Modifications (Change Orders)

Changes to a contract in either scope or price or both are treated as follows:

- If a new distinct performance obligation is added **and is priced** at its stand-alone price, it is treated as a new contract.
- If a new distinct performance obligation is added **and is not priced** at its stand-alone price, reevaluate the contract from Step 2.
- **If it is not a new distinct performance obligation**, a cumulative catch-up adjustment is made by adjusting the total estimated costs and transaction price for the modification.

Modifications where the price is not yet determined are considered variable considerations, and the contractor will estimate the transaction price based on a probability-weighted or most likely amount approach, provided that a significant reversal of revenue will not occur when the price is finally settled.

Timing of Revenue

Under the new standard, a government contractor will evaluate criteria at contract inception to determine whether it satisfies the performance obligation over time. Only if none of the over-time criteria are met will the government contractor recognize revenue at a point in time.

Additional Resources

This is by no means a complete list of the new standard's effect on government contractors. Please consult your financial partners at Ellin & Tucker or one of our Government Contractor Services team members to review the impact of the new standard on your company. Visit us at ellinandtucker.com or call 410.727.5735.

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SUMMARY OF CHANGES TO REVENUE RECOGNITION

FASB Accounting Standards Update No. 2014-09

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update No. 2014-09, developed as part of the convergence initiatives of the FASB and International Accounting Standards Board (IASB) to align accounting standards, reduce industry specific complexities, and shift the thought process of recording revenue from a rules based process to a principles based approach. **This standard replaces nearly all existing revenue recognition guidance**.

The new standard will go into effect in calendar year 2018 for public business entities and calendar year 2019 for private companies. Implementation may also affect earlier periods.

MAIN PROVISIONS

The standard creates the following five steps for recognizing revenue:

1 IDENTIFY THE CONTRACT

A contract is an agreement between a customer and vendor for goods or services. It requires commercial substance, identification of the rights and obligations of each party, and has a high probability of fulfillment.

2 IDENTIFY THE CONTRACT'S SEPARATE PERFORMANCE OBLIGATIONS

These are the distinct goods or services to be delivered. A good or service is considered distinct if it is a separate line item in the contract and the customer can utilize it on a stand-alone basis. The goods or services should not depend on or significantly modify another deliverable.

3 DETERMINE THE TRANSACTION PRICE

The transaction price is the amount the vendor expects to be paid when the goods or services are delivered to the customer. The transaction price takes into account any discounts, financing components, variable and noncash consideration, as well as amounts payable to the customer.

4 ALLOCATE THE TRANSACTION PRICE OVER THE PERFORMANCE OBLIGATIONS

The total transaction price must be allocated to the distinct performance obligations. This is accomplished by accumulating the stand-alone prices of the deliverables and allocating the transaction price on a pro-rata basis. The normal selling price for the goods or services is used to determine stand-alone prices. If such price does not exist, a best estimate can be used.

5 RECOGNIZE REVENUE AS THE ENTITY SATISFIES PERFORMANCE OBLIGATIONS

Revenue is recognized as control of the deliverable passes from the vendor to the customer. This happens either at a point in time (buying groceries) or over time (construction project). Control is considered to have passed when the customer has the ability to use the goods or received benefit of the services. How this transfer takes place determines whether recognition occurs at a point in time or over time.

DISCLOSURES

Specifically, the new standard includes disclosure requirements for:

- Disaggregation of revenue
- Contract balance, including changes during the period
- Performance obligations
- Significant judgements
- Assets recognized to obtain or fulfill a contract, including changes during the period