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Considerations Related to Identifying Contracts With Customers Under Step 1 of the ASC 606 Revenue Recognition Model

This is one of a series of aerospace and defense (A&D) industry spotlights. This series focuses on key accounting and operational matters relevant to companies within the A&D industry.

Overview

Many commercial companies and traditional U.S. government (USG) contractors have contracts for which revenue is recognized over time in accordance with ASC 606.¹ Step 1 of the ASC 606 revenue recognition model, "Identify the contract(s) with a customer,"² is particularly important since government contracts often involve complex arrangements, including long-term contracts, multiple deliverables, and significant customization. The criteria that must be met to establish the existence of a contract between an entity and its customer are intended to demonstrate that there is a valid and genuine transaction between the parties and that they have enforceable rights and obligations that will have true economic consequences.

USG contracts are exchange transactions in which the U.S. government obtains control of goods or services in exchange for consideration. These arrangements are different from government grants, in which an entity receives funding from the government, but the government does not directly receive goods or services in exchange for that funding.

¹ For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification.](#)"

² Quoted from ASC 606-10-05-4.

Correctly identifying a contract and its enforceable rights and obligations is crucial because the rest of the ASC 606 revenue recognition model cannot be applied until a valid contract is in place. Further, varying contracting practices can sometimes make the identification and determination of enforceable rights and obligations difficult. Even if two parties are in basic agreement about the main terms of a contract, no contract would exist if the parties' rights and obligations under the contract are not legally enforceable.

This spotlight discusses key considerations related to identifying contracts with customers under step 1 of the ASC 606 revenue recognition model and is intended to supplement the considerations discussed in Deloitte's Roadmap [Revenue Recognition](#).

Undefinitized or Unfunded Contracts

In scenarios involving undefinitized contract actions and handshake agreements, the criteria for contract existence in ASC 606-10-25-1 could be met for both the funded and unfunded portions of a contract if (1) an entity and its customer have an approved enforceable agreement under which they can identify their enforceable rights and obligations related to the promised goods and services to be transferred and (2) the customer has the ability and intention to pay the entity for the promised goods and services. Contracts can be written, oral, or implied. In determining whether a contract with a customer exists, an entity should focus on what is legally enforceable as a matter of law.

Any unfunded portion of a contract should be evaluated under the variable consideration guidance in ASC 606 in a manner similar to the treatment of award and incentive fees, and it should be included in the transaction price before funding is certain. The entity should include in the transaction price the amount of estimated consideration only to the extent that it is probable that (1) a significant reversal in the amount of cumulative revenue recognized will not occur and (2) collectibility is probable. Therefore, the entity may conclude that both the funded and unfunded portions of the contract could be included in the transaction price, subject to the constraint guidance.

Best-Efforts-Basis, Research-and-Development-Cost-Sharing Arrangements

ASC 912-730 provides guidance on what it refers to as "best-efforts-basis, research-and-development-cost-sharing arrangements." ASC 912-730-05-2 states, in part, that "[c]ontractors may enter into contractual arrangements in which the customer agrees to share the estimated costs of certain research and development activities." In the A&D industry, such research-and-development activities may include the development of a prototype for new or advanced satellite or spacecraft. For a contract of the type described in ASC 912-730-05-2 to be accounted for as a best-efforts-basis, research-and-development-cost-sharing arrangement under ASC 912-730 rather than a contract with a customer that is subject to ASC 606, the following six criteria in ASC 912-730-15-2(a) through (f) must be met:

- a. The activities performed in connection with the contractual arrangement qualify as research and development (see Subtopic 730-10).
- b. The contractor retains a right to the data and results of the research and development activities.
- c. The contractual arrangement obligates the contractor to perform only on a best-efforts basis to achieve the agreed-on objectives of the research and development activity, rather than to deliver a product or service meeting defined performance or other (such as design) specifications.
- d. At the inception of the contract, the contractor and the customer enter into the arrangement with the expectation that costs will be incurred in excess of amounts to be funded. This condition will be met if contractual or other documentation specifically evidences acknowledgment of this expectation by both the contractor and the customer. Implicit in this condition is the existence of significant uncertainty at the date the contractor enters into the arrangement regarding the likelihood of successfully securing follow-on contracts related to the research and development activity.

- e. The research and development arrangement is not combined with other contracts in accordance with the guidance on combining contracts in paragraph 606-10-25-9.
- f. The federal government is the sole or principal expected ultimate customer (including foreign military sales) for the research and development activity or products directly resulting from the research and development activity subject to the arrangements.



Connecting the Dots

Research-and-development activities related to best-efforts-basis, research-and-development-cost-sharing arrangements are aimed at developing or significantly improving a product or service, or a process or technique, regardless of whether that which is being developed or significantly improved is intended for sale or internal use. In other words, research-and-development activities are those activities that have a goal to create or greatly improve a product or process. Examples of research-and-development activities are concept development, engineering design, creation of prototypes, and product testing. Certain activities are not considered research-and-development costs under ASC 730. Costs that are not considered research-and-development costs under ASC 730 include costs incurred to perform a specific contract for other parties, costs incurred to improve marketing or selling techniques, and routine efforts to refine or improve the qualities of an existing product. See ASC 730-10-55-1 and 55-2 for a detailed list of activities that are and are not considered research and development within the scope of ASC 730.

When determining whether the criterion in ASC 912-730-15-2(b) above is met, entities should ensure that the contractual document clearly and explicitly states the contractor's rights. In addition, contractors should evaluate whether there are other contracts with the same customer entered into at or near the same time, as indicated in ASC 912-730-15-2(e) above. If (1) such contracts were negotiated as a package with a single commercial objective, (2) the amount of consideration to be paid in one contract depends on the price or performance of the other contracts, or (3) the goods or services in the contracts are a single performance obligation under ASC 606, the contracts should be accounted for as a single contract under ASC 606 (or under other GAAP if certain contractual elements are subject to guidance outside of ASC 606) rather than a research-and-development contract under ASC 912-730.

If a contract meets all six criteria in ASC 912-730-15-2, it should be accounted for as a best-efforts-basis, research-and-development-cost-sharing arrangement under ASC 912-730. Funds provided by the customer should be recorded as a reduction of the contractor's total research-and-development expenses rather than as revenue from the contract. If timing of cash receipts differs from the timing in which research-and-development expenses are incurred, an asset (receivable) or liability (advance) should be recorded.

Indefinite Delivery, Indefinite Quantity Contracts

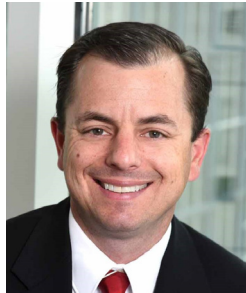
Indefinite delivery, indefinite quantity (IDIQ) contracts can be considered contracts under step 1 of the ASC 606 revenue recognition model if they meet five criteria: mutual approval and commitment, identifiable rights, payment terms, commercial substance, and probable collectibility. An enforceable quantity of goods or services must be explicitly stated in the contract documentation. Initial orders under the IDIQ agreement (e.g., purchase orders, delivery orders, or work directives) demonstrate approval and commitment. However, notional quantities provided during the proposal process do not demonstrate commitment since they do not create enforceable rights and obligations. Once an initial order is placed and the quantity is specified, both the contractor and the customer are committed to performing their respective obligations (e.g., transferring the specified quantity of goods and paying consideration for a specified quantity of goods).

Conclusion

After an entity determines that the criteria for establishing the existence of a contract with a customer under step 1 of the ASC 606 revenue recognition model are met, it needs to apply the other requirements of ASC 606. Stay tuned for Deloitte's upcoming A&D industry spotlights on applying steps 2 through 5 of the ASC 606 revenue recognition model.

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