No. 2014-27
4 September 2014

Technical Line

FASB — final guidance

The new revenue recognition standard — aerospace and defense

The new revenue standard replaces the industry-based revenue recognition guidance that A&D entities use today.

What you need to know

- The new revenue recognition standard is more principles-based than current revenue guidance and will require aerospace and defense entities to exercise more judgment.
- The standard will replace most existing revenue literature, including the revenue guidance in Accounting Standards Codification (ASC) 605-35, *Construction-Type and Production-Type Contracts*, that most aerospace and defense entities use today.
- The key issues for the industry include identifying performance obligations, accounting for contract modifications, applying the constraint to variable consideration, evaluating a significant financing component, measuring progress toward satisfaction of a performance obligation, recognizing contract costs and addressing disclosure requirements.
- The new standard is effective for public entities for fiscal years beginning after 15 December 2016, including interim periods within those years, and for nonpublic entities in years beginning after 15 December 2017.

Overview

Aerospace and defense (A&D) entities may need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS, including the percentage-of-completion (POC) revenue recognition guidance in ASC 605-35 that most A&D entities use today.

The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

Our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), provides an in-depth discussion of the new revenue standard. This publication summarizes certain key implications for A&D entities.

A&D entities may want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on A&D issues. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's A&D industry working group is one of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.

Key considerations

While some of the concepts in the new revenue model are consistent with those in today's guidance for recognizing revenue using the POC method in ASC 605-35, the guidance for accounting for certain elements within many A&D contracts is changing. The new standard also introduces a number of new disclosure requirements.

Identifying the contract

Transactions with customers in the A&D industry include a variety of goods and services that may be formalized in one or more contracts. For example, a single arrangement may include firm commitments for a certain number of units along with options for more items at a predefined price. In contrast, an entity may negotiate an arrangement that includes the sale of a product along with spare parts and/or maintenance services, and include these goods or services in separate contracts.

Under the new standard, A&D entities will have to determine which promises to provide goods or services create enforceable rights and obligations as part of a single contract or separate contracts and whether contracts with the same customers should be combined for accounting purposes. Contracts will have to be combined only when (1) the contract is negotiated as a package with a single commercial objective, (2) the consideration paid in one contract depends on the price or performance of the other contract or (3) goods or services in the contracts form a single performance obligation. Contracts may not be combined with future anticipated contracts that do not yet create enforceable rights and obligations (e.g., initial loss-leader contracts negotiated in anticipation of future profitable contracts).

Identifying performance obligations

The new standard requires an entity to identify all promised goods and services by reviewing the contract terms and its customary business practices. Promised goods and services represent separate performance obligations (i.e., units of accounting) if the goods or services are distinct (i.e., are both capable of being distinct and distinct within the context of the contract) or if the goods and services are part of a series of distinct goods and services that are substantially the same and have the same pattern of transfer to the customer.

This evaluation may be complex when, for example, a contract requires delivery of multiple units that are substantially the same or includes design and testing services along with production of finished goods. In some cases, A&D entities may identify performance obligations under the new standard that are different from the units of accounting (i.e., profit center) identified under ASC 605-35. These differences may change an entity's pattern of revenue recognition and associated profit.

Accounting for contract modifications

Parties to A&D arrangements frequently agree to contract modifications (e.g., change orders) that modify the scope or price (or both) of a contract. The new standard states that "a contract modification exists when the parties to a contract approve a modification that either creates new, or changes existing, enforceable rights and obligations of the parties to the contract." Approvals of a modification may be written, oral or implied by the entity's customary business practices.

A&D entities may need to update certain policies and procedures for estimating revenues.

Generally, the new revenue model is not applied to a modification until it is approved by all parties. However, the standard also states that an entity may have to account for a contract modification before the parties reach final agreement on changes in scope or pricing (or both) once it determines that the revised rights and obligations are enforceable. Further, if the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity will need to estimate the change to the transaction price arising from the modification using the new guidance, which includes an evaluation of whether variable consideration from the contract modification is subject to significant reversal (see section on applying the constraint to variable consideration below).

A&D entities also will have to determine whether to account for a modification as a separate contract, the termination of an old contract and creation of a new contract, or as part of the original contract, based on the nature and pricing of the goods or services included in the modification. To make this determination, A&D entities must decide whether the additional goods and services in the modification are distinct from those in the original contract, distinct from those already provided through the entity's performance and priced commensurate with their standalone selling prices. This conclusion will affect the pattern of revenue recognition from the modification (i.e., whether it will be recognized prospectively or on a cumulative catch-up basis).

The requirement to prospectively recognize revenue from a modification could represent a significant change for many A&D entities. Specifically, if an entity determines that goods and services provided after a contract modification are distinct from the goods or services already provided, the new standard requires that the remaining portion of the original contract and the contract modification be accounted for together on a prospective basis. This would represent a change in practice for A&D entities that currently account for modifications on a cumulative catch-up basis.

Applying the constraint to variable consideration

The consideration received in an A&D arrangement may vary in amount and timing as a result of award fees, incentive fees, discounts, credits or price concessions. For contracts in which the promised consideration is variable, an entity will need to estimate the amount of consideration to which it expects to be entitled. The amount of variable consideration an entity can include in the transaction price is limited to the amount for which it is probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved.

The new standard provides factors that may indicate that revenue is subject to significant reversal, including the susceptibility of the variable consideration to events outside of the entity's influence, the length of time to resolve the uncertainty related to the variable consideration and the entity's experience with similar arrangements.

While A&D entities that use the POC method under ASC 605-35 may already estimate award and incentive fees they expect to earn, A&D entities may need to change their processes for making those estimates and possibly their conclusions about the amount and timing of variable consideration to include in the transaction price due to the constraint.

Evaluating significant financing components

A significant financing component may exist when consideration is prepaid (e.g., customer advances) or is paid after the goods or services are provided. Many A&D contracts include payment terms (e.g., retainage, milestone or progress payments, award/incentive fees, advance payments) that A&D entities will need to evaluate to determine whether any differences in the timing of customer payments and the transfer of goods and services to the customer represent a significant financing component in the contract.

Entities will not be required to adjust the transaction price for a financing component for a variety of reasons, including if it is not significant to the contract, if the period between the customer's payment and the entity's transfer of the goods or services is less than one year or a difference between the promised consideration and the selling price is for reasons other than providing financing to either the entity or the customer (e.g., retainage).

If an entity concludes that a financing component is significant to a contract, it will determine the transaction price by discounting the amount of promised consideration using the same discount rate it would use if it were to enter into a separate financing transaction with the customer.

Determining standalone selling prices

Under the new standard, revenue from an arrangement is allocated to the identified performance obligations based on their relative standalone selling prices. The standard states that the best evidence of the standalone selling price is the observable price of a good or service when the entity sells that good or service in similar circumstances and to similar customers.

The standalone selling price of a good or service may be different from the stated contract price because of various factors that are considered when an arrangement is priced (e.g., price concessions, rebates, free services). While ASC 605-35 provides guidance on contract separation, that guidance does not address allocation of arrangement consideration. In practice, separately negotiated prices for contract components are generally used as the value of separated contract elements. The new guidance, which requires allocation using a relative standalone selling price method, could result in a significant change in practice.

Determining when control of a promised good or service transfers

The new standard requires revenue to be recognized based on the transfer of control of the promised goods or services to the customer. This transfer will occur over time if (1) the customer consumes the benefits of the delivered item as the entity performs, (2) the entity's performance creates or enhances an asset controlled by the customer as it is created, or (3) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date. If one of these three requirements is not met, control of a promised good or service (and revenue recognition) will occur at a point in time.

Many contracts in the A&D industry (e.g., contracts with the US Government) provide title to, or grant a security interest in, work-in-process to the customer, which indicates that the customer controls the asset (and revenue is recognized) as the asset is created or enhanced. However, in arrangements where the customer doesn't have title to, or a security interest in, the work-in-process, an entity's evaluation of whether revenue should be recognized over time will likely require significant judgment about whether the asset has an alternative use and whether the entity has an enforceable right to payment for performance completed to date. Among other factors, A&D entities will need to evaluate the level of customization of the transferred item and the effect of any laws, legislation or legal precedent that could supplement or override contractual payment terms. As a result, the conclusion about whether a performance obligation is satisfied at a point in time or over time could differ across jurisdictions or customers.

Measuring progress toward satisfaction of a performance obligation

The standard provides two methods for measuring progress for performance obligations satisfied over time: input methods (e.g., costs incurred, resources consumed, labor hours expended, time elapsed) or output methods (e.g., surveys of performance completed to date, appraisals of results achieved, units delivered, milestones reached, time elapsed).

While the standard does not say any method is preferable, A&D entities will need to carefully evaluate the facts and circumstances of an arrangement to determine the method that best depicts the entity's performance in transferring control of goods or services to the customer. Entities are required to select a single method for the relevant performance obligations at contract inception, and the standard does not permit a change in methods. In addition, consistent with the guidance in ASC 605-35, entities must demonstrate the ability to reasonably measure progress toward complete satisfaction of a performance obligation in order to recognize revenue over time.

The standard states that it may not be appropriate for entities to use output methods, such as units-of-delivery or units-of-production, because those methods ignore the work-in-process that belongs to the customer (which is common in contracts with the US Government, including the US Foreign Military Sales program). The use of these methods could distort the entity's performance because the entity would not recognize revenue for assets that are created before delivery or completion of production but are controlled by the customer. As a result, the cost-to-cost method (or other input methods that include finished goods and work-in-process in the measurement of progress) may be more appropriately applied by A&D entities to many arrangements with the US Government and other customers where there is a continuous transfer of goods or services (e.g., title to goods transfers to the customer as units are produced). This could result in a significant change in the pattern of revenue recognition by A&D entities and in adjustments to recorded inventories at the date of adoption of the new standard.

A&D entities that determine the cost-to-cost method is the best measure of progress for certain contracts should carefully consider whether costs incurred are proportionate to the entity's progress in satisfying the performance obligation. In many long-term contracts, the customer may obtain control of the goods before the entity provides the services related to those goods (e.g., a contract with the US Government where materials have been purchased by the contractor but have not been used in the development or production of the finished product or service). In this situation, the standard indicates that using a measure of progress based on costs incurred for such a contract may be inappropriately affected by the purchase of these goods and that a pure application of costs incurred as the measure of progress would result in overstated revenue. The standard indicates that in such circumstances, recognizing revenue at an amount equal to the cost of the goods used (rather than cost incurred on the contract) may be a better way to measure progress because the cost incurred is not proportionate to an entity's progress in satisfying a performance obligation.

Recognizing contract costs

ASC 340-40, *Other Assets and Deferred Costs — Contracts with Customers*, was added to codify guidance on other assets and deferred costs relating to contracts with customers and will replace guidance in ASC 605-35. The new guidance specifies the accounting for costs an entity incurs in obtaining and fulfilling a contract to provide goods and services to customers. Such costs must be capitalized when certain conditions are met.

The standard does not permit entities to defer costs in order to normalize profit margins. This may represent a change for some entities when accounting for production costs under long-term contracts.

Disclosure requirements

The new standard provides disclosure requirements about the amount and timing of revenue that an entity expects to recognize from the remaining performance obligations in its existing contracts, subject to limited exceptions granted as practical expedients.

A number of entities in the A&D industry currently disclose information about their contracts, which is commonly referred to as "backlog" information. However, this information is typically provided outside of the financial statements (e.g., in the MD&A section of Form 10-K and Form 10-Q filings) and may not be comparable across entities because entities may define backlog differently.

The new requirements may significantly change the information that A&D entities disclose. In addition, while A&D entities may currently have formal processes for calculating backlog information, they may need to enhance these processes and add internal controls because the disclosures will be included in the notes to the financial statements and will be subject to audit.

Next steps

- Entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard.
- A&D entities also may want to monitor the discussions of the Boards, the Securities and Exchange Commission (SEC) staff, the TRG and the A&D industry working group formed by the AICPA.
- Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.