

In depth

A look at current financial reporting issues



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What's inside:

Overview.....	1
Scope.....	2
Identify the contract.....	2
Identify performance obligations	5
Determine the transaction price.....	9
Allocate the transaction price.....	14
Recognize revenue.....	15
Other considerations.....	21

New revenue guidance Implementation in the aerospace & defense sector

At a glance

Public companies must adopt the new revenue standards in 2018. Almost all entities will be affected to some extent by the new guidance, though the effect will vary depending on industry and current accounting practices. Although originally issued as a converged standard, the FASB and IASB have made slightly different amendments so the ultimate application of the guidance could differ under US GAAP and IFRS.

The Revenue Recognition Transition Resource Group (TRG) has discussed various implementation issues impacting companies across many industries. These discussions may provide helpful insight into application of the guidance. The SEC expects registrants to consider these discussions in applying the new guidance.

This publication reflects the implementation developments over the past few years and highlights certain challenges specific to entities in the aerospace and defense industry. The content in this publication should be considered together with our [Revenue guide](#), available at CFODirect.com.

Overview

The FASB and IASB developed a single, comprehensive revenue recognition model for all contracts with customers to achieve greater consistency in the recognition and presentation of revenue. The model in the new standards is a five-step model that results in an entity recording revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Revenue is recognized based on the satisfaction of performance obligations, which occurs when control of a good or service transfers to a customer.

Scope

Defense and commercial aviation equipment programs are often complex and performance under these contracts typically spans multiple years. For entities reporting under current US GAAP, these programs generally follow percentage of completion accounting (“construction contract guidance”), codified within ASC 605-35. Service contracts are typically in the scope of ASC 605-10-S99. Under IFRS, IAS 18, *Revenue*, and IAS 11, *Construction contracts*, are commonly applied to A&D arrangements, with IAS 18 commonly followed for service arrangements.

The revenue standards (ASC 606 and IFRS 15, *Revenue from Contracts with Customers*) will replace substantially all existing revenue guidance under US GAAP and IFRS. Given the complexity of revenue arrangements and the diverse accounting practices that currently exist, the new standards will significantly affect many entities in the aerospace and defense (A&D) industry. The standards may result in accelerated revenues, increased margin volatility, and an increase in the use of professional judgment when determining the appropriate accounting model for contracts with customers.

This supplement highlights some of the specific areas of judgment and potential changes in accounting for revenue transactions under the new standards. While this supplement focuses on technical accounting areas that may require judgments, we encourage A&D entities to engage across functions (e.g., legal, information technology, supply chain) due to the potential organization-wide impacts caused by changes in revenue recognition.



1. Identify the contract

The first step in applying the new revenue standards is to identify the contract. A company may enter into multiple contracts with the same customer at the same time. The contracts could also be affected by subsequent modifications (such as change orders).

New standards	Current US GAAP	Current IFRS
<p>Combining contracts</p> <p>Contracts will be combined and accounted for as a single contract only if they are entered into at or near the same time, with the same customer (or related parties), and one or more of the following criteria are met:</p> <ul style="list-style-type: none"> • The contracts are negotiated as a package with a single commercial objective. • The amount of consideration to be paid in one contract depends on the price or performance of the other contract. • The goods or services promised in the separate contracts are a single performance obligation. 	<p>Combining contracts is permitted provided certain criteria are met. Combining is not required as long as the underlying economics of the transaction are fairly reflected.</p>	<p>Combining contracts is required when the economic substance of two or more contracts is clearly linked as a single project.</p>

New standards	Current US GAAP	Current IFRS
<p>Contract modifications (for example, change orders)</p> <p>A contract modification occurs when the parties approve a change that either creates new or changes the existing enforceable rights and obligations. Approval can be in writing, oral, or implied by customary business practices. Management will need to determine when a modification, such as a claim or unpriced change order, is approved and therefore creates enforceable rights and obligations. Revenue related to a modification is not recognized until it is approved by the parties.</p> <p>A contract modification is accounted for as a separate contract if:</p> <ul style="list-style-type: none"> the modification promises distinct goods or services that result in a separate performance obligation; and the entity has a right to consideration that reflects the standalone selling price of the additional goods or services. <p>A modification that is not a separate contract is accounted for either as:</p> <ul style="list-style-type: none"> A prospective adjustment if the goods or services in the modification are distinct from those transferred before the modification. The remaining consideration in the original contract is combined with the consideration promised in the modification to create a new transaction price that is then allocated to all remaining performance obligations. A cumulative adjustment to contract revenue if the remaining goods and services are not distinct and are part of a single performance obligation that is partially satisfied. 	<p>A change order is included in contract revenue when it is probable that the customer will approve the change order and the amount of revenue can be reliably measured.</p> <p>US GAAP includes detailed revenue and cost guidance on the accounting for unpriced change orders (i.e., those in which the work to be performed is defined, but the price is not).</p>	<p>Under IAS 11, a change order (known as a variation) is included in contract revenue when it is probable that the customer will approve the change order and the amount of revenue can be reliably measured.</p> <p>There is no specific guidance on the accounting for unpriced change orders.</p>

Impact - both US GAAP and IFRS

If the combination criteria are met, contracts must be combined, which is a change from the election permitted under current US GAAP, although the criteria for combining contracts do not differ significantly between current US GAAP and the new revenue standards. For entities reporting under IFRS, no significant change is expected given that

combining contracts is required under current IFRS if certain criteria, similar to those in the new standards, are met. Additionally, current accounting guidance allows entities to combine contracts with multiple customers when the contracts are in essence an agreement to do a single project, negotiated as a package, with entities that are in substance a single customer. The new standards specify that only contracts with the same customer (or related parties of the customer) are allowed to be combined. This may result in fewer contracts being combined under the new revenue standards compared to current practice.

It is common in the A&D industry for customers to change the original contract specifications and requirements. Contract modifications under both current guidance and the new standards require judgment to determine whether they should be combined with the original contract. Current accounting guidance generally focuses on how interrelated the contract modification is with the existing contract and the overall economics of the arrangement. The new standards have eliminated the requirement to consider the economics of the arrangement and rather focuses on whether the modification adds distinct goods or services at standalone selling price. While the explicit requirement to consider the economics of the modification have been eliminated, the indicators used to determine whether a good or service is distinct includes consideration of the value provided to the customer from all of the goods or services identified in the contract. As a result, A&D entities should continue to focus on whether the utility of the bundle of goods and services (inclusive of any modifications) is significantly increased when determining whether a modification adds distinct goods or services. If distinct goods or services are not added, the modification should be treated as a cumulative adjustment to an existing performance obligation.

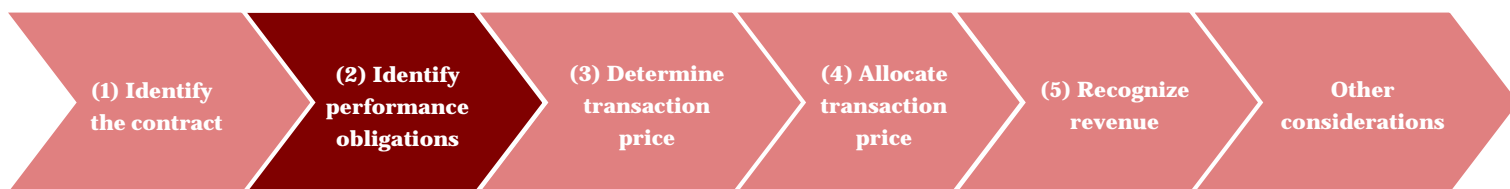
Example 1-1 – Unpriced change orders

Facts: A contractor enters into a contract with a military customer to develop an aircraft system. The entity concludes that the contract contains a single performance obligation. After development starts but before it is finished, the customer changes the specifications of the system. The contractor is asked to process the changes; however, the price of the change has not yet been approved and is not expected to be approved before the development is completed. These types of changes are common and the contractor has a history of executing unpriced change orders.

When should the contractor account for these change orders?

Discussion: The changes in the system specifications should be accounted for when a contract modification exists. A contract modification, such as an unpriced change order, exists when the parties to the contract approve a modification that creates or changes the enforceable rights and obligations of the parties. Determining whether there is a valid expectation that the price modification will be approved is based on facts and circumstances. The contractor may be able to determine that it expects the price of the scope change to be approved based on its historical experience. If so, the contractor should account for the changes in the system specifications upon making the determination that the change order is legally enforceable. The contractor should estimate the transaction price based on an expected value or most likely amount approach (whichever is most predictive). The change order will be included in the transaction price, provided that it is probable (US GAAP) or highly probable (IFRS) that a significant reversal in the amount of cumulative revenue recognized will not occur when the price of the change order is approved (refer to the “Variable consideration and constraint on revenue recognition” section). Estimates of unpriced change orders need to be re-evaluated each reporting period.

The contractor will also need to determine whether the unpriced change order should be accounted for prospectively or as a cumulative catch-up adjustment to the revenue recognized for performance obligations that have been satisfied or partially satisfied. In this example, the change order is not distinct as the activities are not separately identifiable from other development activities in the contract. As a result, the contractor should update the transaction price and measure of progress towards completion of the contract accordingly. The contractor would recognize the effect of the contract modification as revenue (or as a reduction of revenue) at the date of the contract modification on a cumulative catch-up basis.



2. Identify performance obligations

A performance obligation is a promise to transfer a distinct good or service to a customer. It is the unit of account to which the revenue standards are applied and ultimately determines when and how revenue is recognized. The initial identification of performance obligations could significantly influence the level of accounting work performed (e.g., the number of Estimates at Completion (EACs)) and how future modifications will be treated. Determining the separate performance obligations might not be simple due to the complexity of many A&D contracts. Many commonly contain integrated systems and/or combinations of products and services over extended periods of time.

Under current guidance, entities often account for each contract in the scope of construction contract guidance at the contract level, except in circumstances when it meets the criteria for combining contracts or segmenting a contract. The new standards require the identification of the performance obligations. Once performance obligations are determined, EACs will commonly be prepared for each performance obligation that is recognized over time using a cost to cost measure of progress. Regardless of whether there is a change in the level at which revenue is recognized, an entity will need to consider whether its processes and controls for identifying the level at which revenue is measured and recognized will need to be updated.

New standards	Current US GAAP	Current IFRS
<p>Identify performance obligations</p> <p>At contract inception, an entity should assess the goods or services promised in a contract with a customer and identify as a performance obligation each promise to transfer to the customer either:</p> <ul style="list-style-type: none"> • A good or service (or a bundle of goods or services) that is distinct • A series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. This is the case if both the following criteria are met: <ul style="list-style-type: none"> • Each distinct good or service in the series that the entity promises to transfer to the customer would be a performance obligation satisfied over time. • The same method would be used to measure the entity’s progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer. 	<p>The unit of account for measuring contract performance and recognizing revenue is typically the contract. A series of contracts may be combined or a contract may be segmented if the criteria for combining or segmenting contracts are met.</p> <p>There is no further guidance for separately accounting for more than one deliverable in a construction contract under the construction contract guidance.</p>	<p>The unit of account for measuring contract performance and recognizing revenue is typically the contract. In some circumstances, IAS 11 requires that an entity combine or segment contracts in order to reflect the substance of the contract or of a group of contracts.</p> <p>There is no further guidance for separately accounting for more than one deliverable in a construction contract.</p>

New standards	Current US GAAP	Current IFRS
<p data-bbox="142 235 451 264"><i>Distinct goods or services</i></p> <p data-bbox="142 281 581 369">A good or service (or bundle of goods or services) is distinct if both of the following criteria are met:</p> <ul data-bbox="142 390 586 751" style="list-style-type: none"> <li data-bbox="142 390 586 569">• 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 (i.e., capable of being distinct). <li data-bbox="142 573 586 751">• The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., distinct in the context of the contract). <p data-bbox="142 768 581 947">Determining whether the good or service is distinct requires judgment. One factor that would indicate that the good or service is distinct is if the entity regularly sells a good or service separately.</p> <p data-bbox="142 963 586 1083">Factors that indicate that two or more promises to transfer goods or services are not separately identifiable include:</p> <ul data-bbox="142 1100 586 1745" style="list-style-type: none"> <li data-bbox="142 1100 586 1556">• The entity provides a significant service of integrating goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. This occurs when the entity is using the goods or services as inputs to produce or deliver the output or outputs specified by the customer. A combined output (or outputs) might include more than one phase, element, or unit. <li data-bbox="142 1560 586 1745">• One or more of the goods or services significantly modifies or is significantly modified or customized by one or more of the other goods or services promised in the contract. 		

New standards	Current US GAAP	Current IFRS
<ul style="list-style-type: none"> The goods or services are highly interdependent or highly interrelated with other promised goods or services in the contract such that each of the goods or services is significantly affected by one or more of the other goods or services. 		
<p>Contract options</p> <p>Customer options that provide a material right to the customer (such as a free or discounted good or service) give rise to a separate performance obligation. In this case, the performance obligation is the option itself, rather than the underlying goods or services. Management will allocate a portion of the transaction price to such options, and recognize revenue allocated to the option when the additional goods or services are transferred to the customer, or when the option expires.</p> <p>If an option is not a material right and is not a measure of usage that should be treated as variable consideration, revenue accounting is not impacted until exercise even if exercise of the option is virtually assured. Upon exercise, the option would be treated as a contract modification to determine the appropriate accounting.</p>	<p>Contract options, which are generally an option to purchase additional units of a product at previously agreed-upon pricing, might be included in the original contract or accounted for separately, depending on the circumstances.</p> <p>When an option is determined to be substantive, an entity evaluates whether that option has been offered at a significant incremental discount. If the discount is significant, a presumption is created that an additional deliverable is being offered in the arrangement requiring a portion of the arrangement consideration to be deferred at inception.</p>	<p>Contract options, which are generally an option to purchase additional units of a product at previously agreed-upon pricing, might be included in the original contract or accounted for separately, depending on the nature of the option.</p> <p>If an entity grants to its customers, as part of a sales transaction, an option to receive a discounted good or service in the future, the entity accounts for that option as a separate component of the arrangement and therefore allocates consideration between the initial good or service provided and the option.</p>

Impact - both US GAAP and IFRS

Once a contract is identified, entities will need to apply judgment regarding the identification of performance obligations and when promised goods or services should be separately accounted for or combined. This evaluation may cause fewer of an entity's contracts to be accounted for at the contract level, resulting in increased margin variability and more complex revenue accounting models. Certain A&D entities may segment contracts based on differences in contract line item number (CLIN) pricing (e.g., cost-type, fixed price) under current US GAAP. Under the new standards, each CLIN will need to be reviewed to determine whether it represents a distinct good or service, whether there are multiple distinct goods or services within the CLIN, or whether the CLIN should be combined with other CLINs. In performing this assessment, the pricing structure may be an indicator of whether a CLIN is distinct from other goods or services; however, the CLIN may not be distinct if it is an input, along with other CLINs, to create a combined output for the customer (i.e., a single performance obligation).

The new standards introduce the concept of determining whether a good or service (or a bundle of goods or services) is distinct. Each distinct good or service (or bundle of goods and services) will be accounted for as a separate performance obligation unless the distinct good or service is substantially the same, is recognized over time and has the same pattern of transfer to the customer. In this case, the distinct goods or services are required to be aggregated into a single performance obligation under the series guidance. However, when applying the series guidance, the entity is required to consider each distinct good or service in the series when allocating variable consideration and accounting for contract modifications. While a single performance obligation may be identified under the series guidance, the allocation of

variable consideration and manner in which modifications are treated may be different than when goods and services are bundled into a single performance obligation because they are not distinct.

A&D contracts often involve complex integrated systems and related services. Judgment will be required to determine whether aspects of these systems and related services represent a distinct good or service. In determining whether individual goods or services should be combined, entities should focus on the nature of their promise to their customer and whether the individual goods and services have a transformational relationship. That is, entities should consider whether a good or service being provided to the customer provides more utility or value on a combined basis than the sum of the individual value of each good or service in the contract.

Under current accounting standards, goods or services offered as part of an option to acquire additional goods or services may have been included as part of the initial accounting at contract inception if certain criteria were met. Under the new standards, the goods or services underlying an option are explicitly precluded from being included in the contract until the obligation to purchase becomes legally enforceable (which is typically upon exercise of the option or receipt of a purchase order). The exception is when an option to acquire additional goods or services provides the customer with a material right, which would create a separate performance obligation at contract inception. The inability to include optional purchases may increase revenue and margin variability under the new standards for many A&D entities.

Example 2-1 – Identifying performance obligations – design and manufacture

Facts: A contractor enters into a single contract to design a new experimental aircraft and manufacture ten identical prototype units of the aircraft. The new aircraft design includes key functionality that has not been proven in an aircraft application. It is expected that the design of the aircraft will be modified during production of the prototypes and that any given prototype might be modified based on the design changes and learnings from other prototypes. The deliverables to the customer are the prototype units. The customer receives significant utility from the contractor providing both the design and manufacturing services.

Are the design services and the manufacture of the prototypes distinct performance obligations?

Discussion: The specific facts and circumstances of the contract will need to be assessed, to determine whether the design activities represent the transfer of a service to the customer and whether the customer can benefit from the design services without the prototypes. Even if the design services are capable of being distinct, the contractor may still be required to account for the design and manufacture as a single performance obligation if the contractor provides a significant service by integrating goods or services promised in the contract or if one good or service significantly modifies or customizes other goods or services in the contract.

In this particular fact pattern, the entity expects to continually modify the prototypes and design due to changes that are expected to occur during production. While the design and production might have benefits on their own, in the context of the contract, they are not separable. The entity would conclude that the design and manufacture are highly dependent on each other and highly interrelated and that the value to the customer is significantly increased by having one party manage the concurrent design and production efforts.

Example 2-2 – Identifying performance obligations – series of distinct goods – commercial contract

Facts: A commercial helicopter engine maker has a contract to provide engines for 50 single-engine helicopters over a 36-month period. The engine specified in the contract is a fully developed engine that the engine maker has been manufacturing and selling for the past five years. Design services are not included in the contract. The engine maker has had other similar contracts to sell this specific engine in quantities that range from 20 to 100 engines per contract. Additionally, the engine maker sells individual engines (single units) as spares and components of the engine as spare parts. The engine maker has concluded that each engine is a distinct good that is separately identifiable because (1) they are not providing a service of integrating the engine with another good or service; (2) the engines do not modify any other good or service in the contract; and (3) the engines are not highly interrelated with other engines such that a customer decision not to buy certain engines would not significantly affect the engines being purchased. Based on the contract terms, the engine maker concludes the contract meets the criteria to be recognized over time (described in Step 5). Furthermore, the engine maker concludes that each engine is substantially the same and has the same pattern of transfer to the customer.

How many performance obligations are in the contract?

Discussion: All 50 engines would be considered a single performance obligation. In this fact pattern, the engine maker has concluded that each engine is a distinct good. The engines qualify for the series guidance since they (a) are substantially the same, and (b) each engine in the series would meet the criteria to be a performance obligation satisfied over time and the same method would be used to measure the entity's progress to depict the transfer of each engine. If any of these criteria were not met, then each engine would be a separate performance obligation,

It is important to note that while engine components are routinely sold, the integration of individual components within each engine is essential to what the contractor has promised to the customer in the contract (i.e., they need to deliver a fully functioning engine). The standards clarify that the evaluation should be performed on the good or service in its completed state. Therefore, the components do not represent separate performance obligations. The answer would likely be different if a customer was ordering a bundle of components to maintain engines it already operates. In that case, each component may be a separate performance obligation as the nature of the promise would be different.

Example 2-3 – Identifying performance obligations – distinct goods - government contract

Facts: A government contractor has a contract to provide 50 weapon systems to a Country A's government over a two-year period. The contractor has been manufacturing and selling this equipment for the past three years for Country A's government and approved foreign nations. The terms of the contract require the contractor to establish a manufacturing process in order to produce the units to the government's specifications. The contractor has devoted manufacturing lines and management teams for this particular weapon system.

As the prime contractor, the entity is responsible for the overall management of the contract. This requires the performance and integration of various activities, including procuring materials, identifying and managing subcontractors, and performing manufacturing, assembly, and testing in order to produce all 50 weapon systems on time and in accordance with the government's specifications while establishing the operational capability of the systems.

How many performance obligations are in the contract?

Discussion: The contractor will likely identify one performance obligation. The contractor is responsible for establishing a manufacturing process, delivering the full complement of devices for which the customer has contracted in accordance with the government's specifications, and establishing the operational capability of the systems. While each weapon system is capable of being distinct, they are not distinct in the context of the contract. The contractor provides a significant integration service of establishing the manufacturing process, combining the inputs, and delivering the full complement of devices for Country A's government such that the utility of the bundle of the production activities exceeds the utility of each activity or individual unit sold separately. It is important to determine whether the bundle of goods and activities is managed and provided as a package at or around the same time. Absent being provided at or around the same time, it is unlikely that goods or services would have a transformational relationship and add significant incremental utility to the bundle. As a result, they would not be a single performance obligation. For a further example on the identification of performance obligations and the evaluation of distinct goods, refer to Examples 10 and 11 in the standards.



3. Determine the transaction price

The transaction price is the amount of consideration an entity expects to be entitled to in exchange for transferring promised goods or services to a customer. The transaction price may include an element of consideration that is variable or contingent on the outcome of future events. Examples of arrangements in the A&D industry with variable consideration include contracts with award and incentive fees for achieving a successful outcome or completion by a specific date or service arrangements when payments are received based on the customer's utilization of an underlying asset.

Long-term contracts with various payment terms are also common in the A&D industry. Under the new standards, companies will need to assess the timing of customer payments in relation to the transfer of goods or services. Differences in timing could indicate that a significant financing component exists, either with the entity or its customer, which should be reflected in the transaction price. This could result in the company recognizing interest income or expense, and total revenue could be more or less than the consideration received.

New standards	Current US GAAP	Current IFRS
<p>Awards and incentive fees</p> <p>Awards/incentive payments are estimated using either a probability-weighted approach or an estimate of the most likely amount (whichever is more predictive).</p> <p>Awards/incentive payments should be included in the transaction price to the extent that it is probable [US GAAP] or highly probable [IFRS] that a significant cumulative revenue reversal will not occur in future periods when the uncertainty associated with the variable consideration is subsequently resolved. Factors that could increase the likelihood or the magnitude of a revenue reversal include:</p> <ul style="list-style-type: none"> • The amount of consideration is highly susceptible to factors outside the entity’s influence. • The uncertainty about the amount of consideration is not expected to be resolved for a long period of time. • The entity’s experience (or other evidence) with similar types of contracts is limited, or that experience has limited predictive value. • The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances. • The contract has a large number and broad range of possible consideration amounts. 	<p>Awards/incentive payments are included in contract revenue when the specified performance standards are probable of being met or exceeded and the amount can be reliably measured.</p>	<p>Awards/incentive payments are included in contract revenue when the specified performance standards are probable of being met or exceeded and the amount can be reliably measured.</p>

New standards	Current US GAAP	Current IFRS
<p>Claims</p> <p>Entities can submit claims to their customers for additional transaction consideration due to costs being higher than expected. Claims with a contractual or legal basis create an enforceable right and are accounted for as variable consideration. The treatment of such claims is similar to the treatment for awards/incentive fees.</p>	<p>A claim is recorded as contract revenue when it is probable and can be estimated reliably (determined based on specific criteria), but only to the extent of contract costs incurred. To meet the criteria to be estimated reliably, the claim must have contractual or legal basis and be supported by objective and verifiable evidence. Profits on claims are not recorded until they are realized.</p>	<p>A claim is included in contract revenue only if negotiations have reached an advanced stage such that it is probable the customer will accept the claim and the amount of revenue can be reliably measured.</p>
<p>Significant financing component</p> <p>Contract revenue should reflect the time value of money if the contract includes a significant financing component. Entities should consider the following factors to determine if a significant financing component exists:</p> <ul style="list-style-type: none"> • The difference, if any, between the amount the customer promises to pay and the cash selling price of the goods or services. • The length of time between when the entity satisfies the performance obligation and when the customer pays for the goods or services, and the prevailing interest rates in the market. <p>All relevant facts and circumstances should be considered when assessing if a contract contains a financing component, including whether the intent of the parties is to provide financing.</p> <p>Management should use a discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception, including consideration of credit risk. The discount rate does not need to be updated subsequent to contract inception.</p>	<p>Receivables are discounted in limited situations, including receivables with payment terms longer than one year. The interest component is computed based the stated rate in the agreement or on a market rate when discounting is required.</p>	<p>Receivables are discounted when the inflow of cash or cash equivalents is deferred and the impact is material.</p>

New standards	Current US GAAP	Current IFRS
An entity is not required to reflect the time value of money in the transaction price when the period between payment by the customer and the transfer of goods and/or services is less than one year, even if the contract itself is for more than one year.		

Impact - both US GAAP and IFRS

The evaluation of variable consideration will require judgment. In some cases, revenue will be recognized before all contingencies are resolved, which might be earlier than under current guidance. Entities may need to recognize the minimum amount of revenue they expect to be entitled to when control transfers as long as it is probable [US GAAP] or highly probable [IFRS] that the amount of cumulative revenue recognized is not subject to a significant reversal of cumulative revenue in the future if estimates of variable consideration change. The Boards intend that probable under US GAAP and highly probable under IFRS mean the same thing. Estimates of variable consideration, including claims, do not arise from optional purchases.

Using a most likely or probability-weighted estimate approach to determine the transaction price in arrangements involving bonuses, claims, and award fees may provide results similar to today when estimating the contract price under the construction contract guidance; however, process and control documentation may be required to be updated. Variable consideration that results in cash payments to a customer for late deliveries, liquidated damages, or product performance guarantees that are not a promised service should also be estimated using the new standards' variable consideration model and generally results in a reduction of the transaction price.

Additionally, service contracts that may have historically been accounted for outside of construction accounting may not have recognized revenue for variable consideration due to the contingent revenue limitation under US GAAP. Variable consideration will need to be estimated for these contracts under the new standards, which may result in the recognition of revenue earlier than under current guidance.

Assessing whether a contract has a significant financing component will require judgment. An entity must determine when goods or services are transferred to the customer compared to when consideration is due to determine if a significant financing component might exist. If there is a difference between performance and payment, an entity will need to consider other factors to assess whether the intent of the parties was to provide financing and whether the financing is significant in the context of the contract. As a practical expedient, an entity does not need to assess whether a significant financing component exists if the difference between performance and payment is one year or less.

A&D contract terms often contain provisions for the contractor to receive progress payments as work progresses. Progress payments that are commensurate with the progress toward completion generally indicate there is not a significant financing component in the contract. This is typical in government contracts in which the government obtains control of the goods as the work is performed. However, in some commercial contracts, transfer may occur at a point in time, which could result in a timing difference greater than one year. For example, in the case of a contract for the sale of an aircraft when control to the customer transfers as delivered, significant upfront or advance payments could indicate that the contract includes a financing component. If determined to have a financing component, entities should consider whether the financing is significant in the context of the contract. In general, the identification of a significant financing component in arrangements is more likely in contracts recognized at a point in time and for payments received well before or after the related revenue is recognized

Example 3-1 – Award fees

Facts: A contractor enters into a contract for a satellite launch for the government. The contract price is \$250 million plus a \$25 million award fee if the system is placed into orbit by a specified date. The contract is expected to take three years to complete. The contractor has a long history of rocket launches. The award fee is binary and payable in full upon successful launch of the satellite. That is, the contractor will receive no award fee if the launch is unsuccessful or if the launch is successful after the target date. The contractor believes, based on its long history of relevant experience with similar programs, that it is 95% likely that the contract will be completed successfully and in advance of the target date. The contractor determines that the performance obligation will be satisfied over time.

How should the contractor account for the award fee?

Discussion: The contractor is likely to conclude, given the binary award fee, that it is appropriate to use the most likely amount approach in determining the amount of variable consideration to include in the estimate of the transaction price. The contract's transaction price is therefore \$275 million: the fixed contract price of \$250 million plus the \$25 million award fee (the most likely amount). This estimate should be regularly revised and adjusted, as appropriate, using a cumulative catch-up approach, which is consistent with current practice.

The contractor will need to determine whether it is probable [US GAAP] or highly probable [IFRS] that a significant reversal in the amount of cumulative revenue recognized will not occur in the future. The following indicators might suggest that variable consideration would not result in a significant reversal of cumulative revenue recognized in the future:

- It is largely within the contractor's control to complete the work before the targeted date.
- The uncertainty is expected to be resolved before three years.
- The contractor has a long history of performing this type of work on similar programs.
- The contractor does not expect that the payment terms will change.
- There are only two possible final consideration amounts.

The contractor might conclude in these circumstances that it is probable [US GAAP] or highly probable [IFRS] that a significant reversal in the amount of cumulative revenue recognized will not occur in the future. The new guidance should not result in a significant change from today's accounting for variable consideration in many A&D contracts, but an assessment will need to be made based on the specific facts and circumstances of each contract. Additionally, as estimates on total award fees to be received are periodically updated, new required disclosures on the amount of unfulfilled performance obligations will need to be updated timely.

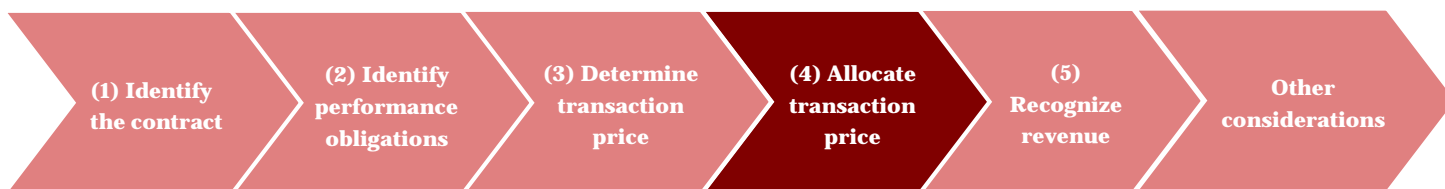
Example 3-2 – Claims

Facts: Assume the same fact pattern as Example 3-1, except that due to reasons outside of the contractor's control (for example, customer-caused delays), the cost of the contract far exceeds original estimates, but a profit is still expected in the contract. The contractor submits a claim against the government to recover a portion of these costs. The claim process is in its early stages, but the contractor has a long history of successfully negotiating claims with the government.

How should the contractor account for the claim?

Discussion: Claims are highly susceptible to external factors (such as the judgment of third parties), and the possible outcomes are highly variable. The contractor might have experience in successfully negotiating claims; however, before the contractor can include claims in its estimate of contract price, it would have to assess whether (1) the claim is enforceable under the contract and (2) it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the claim is resolved. Assuming the contractor determines that the claim is enforceable under the contract, the contractor would evaluate factors such as whether the amount of consideration is highly susceptible to factors outside of their control, relevant experience with similar claims, and the period of time before resolution of the claim to determine the likelihood or magnitude of a revenue reversal.

Costs related to claims may also change under the new standards due to the elimination of the explicit claims guidance in current construction accounting. If costs relate to an existing performance obligation for which the contractor is seeking additional compensation, they may need to be expensed as incurred. This could result in a loss or a determination that the contract is onerous. If the costs, however, represent a modification to the contractor's existing performance obligations under the current requirements of the contract, it may be appropriate to capitalize the costs if they meet the new standards' fulfillment cost guidance for anticipated contracts (e.g., the anticipated future modification of the arrangement for additional scope and transaction price) or other GAAP guidance governing capitalization.

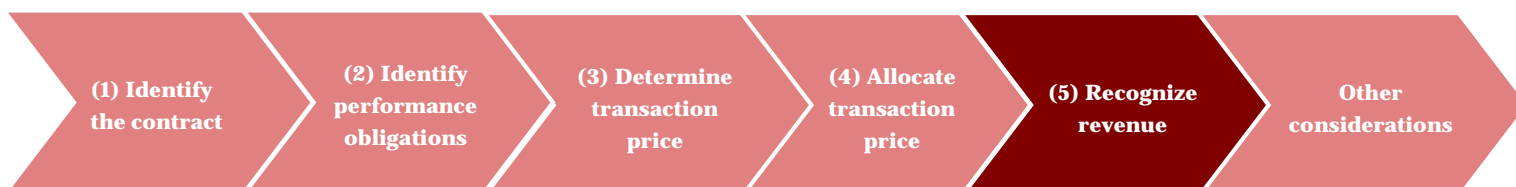


4. Allocate the transaction price

The transaction price is allocated to each performance obligation based on the relative standalone selling prices of the goods or services being provided to the customer. There may be arrangements in the A&D industry when a determination will need to be made about whether to allocate variable consideration (for example, award or incentive payments) to only one performance obligation, rather than across multiple performance obligations within the contract. A company may allocate variable consideration entirely to specific performance obligations when certain conditions are met.

New standards	Current US GAAP	Current IFRS
<p>The transaction price (and any subsequent changes in estimate of the transaction price) is allocated to each separate performance obligation based on the relative standalone selling price of each performance obligation. The best evidence of a standalone selling price is the observable price of a good or service when sold separately.</p> <p>The standalone selling price should be estimated if the actual selling price is not directly observable. The standards do not prescribe a specific estimation method. For example, a contractor might use cost plus a reasonable margin to estimate the selling price of a good or service. A company should maximize the use of observable inputs when estimating the standalone selling price.</p> <p>Companies may use a residual approach to estimate the standalone selling price if the standalone selling price of a good or service is highly variable or uncertain.</p> <p>A company should also allocate a discount entirely to one or more, but not all, performance obligations if all of the following criteria are met:</p> <ul style="list-style-type: none"> The company regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis. 	<p>Except for allocation guidance related to contract segmentation, there is no explicit guidance on allocating contract revenue to multiple deliverables in a construction contract, given the presumption that the contract is the profit center for determining revenue recognition.</p>	<p>Except for allocation guidance related to contract segmentation, there is no explicit guidance on allocating contract revenue to multiple deliverables in a construction contract, given the presumption that the contract is the profit center for determining revenue recognition.</p>

New standards	Current US GAAP	Current IFRS
<ul style="list-style-type: none"> The company also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle. The discount attributable to each bundle of goods or services is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligations to which the entire discount in the contract belongs. <p>Variable consideration (and subsequent changes in the measurement of that consideration) should be allocated entirely to a single performance obligation if:</p> <ul style="list-style-type: none"> payment of the variable consideration under the contract relates specifically to the performance obligation; and such allocation is consistent with the overall allocation objective. 		



5. Recognize revenue

Under the current standards, entities in the A&D industry often use percentage-of-completion accounting to recognize revenue as activities are performed. Percentage of completion is often measured at the contract level (under US GAAP) and using either output methods, such as units of delivery, or input methods, such as cost incurred compared to total estimated cost. Under the new standards, revenue is recognized at the performance obligation level upon the satisfaction of a contractor's performance obligations, which occurs when (or as) control of a good or service transfers to the customer, which can occur either at a point in time or over time. Many A&D contracts will transfer control of a good or service over time. Entities will need to perform a careful assessment of when control transfers and which measurement of recognition faithfully depicts performance towards satisfying the underlying performance obligation.

New standards	Current U.S. GAAP	Current IFRS
<p>Transfer of control</p> <p>Revenue is recognized upon the satisfaction of performance obligations, which occurs when (or as) control of the good or service transfers to the customer. Control can transfer at a point in time or over time.</p> <p><i>Transfer over time</i></p> <p>A performance obligation is satisfied over time if any of the following criteria are met:</p> <ul style="list-style-type: none"> • The customer simultaneously receives and consumes all of the benefits provided by the entity's performance as the entity performs. • The entity's performance creates or enhances an asset (work-in-progress) that the customer controls as the asset is created or enhanced. • 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. <p><i>Alternative use</i></p> <p>An asset does not have alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset for another use during the creation or enhancement of that asset. The assessment of alternative use is made at contract inception and is not updated for changes in facts or circumstances unless the parties to the contract approve a contract modification. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the entity would be able to readily direct the asset for another use. Rather, an entity should consider whether it can fulfill other contractual obligations to other customers with the asset while also fulfilling its obligations to the customer's contract under assessment.</p> <p><i>Right to payment</i></p> <p>At any time throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to</p>	<p>Revenue is recognized using the percentage-of-completion method when reliable estimates of the extent of progress toward completion, contract revenues, and contract costs are available. In addition to requiring reliable estimates, the percentage-of-completion method can be used in circumstances in which all of the following conditions exist:</p> <ul style="list-style-type: none"> • Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement. • The buyer can be expected to satisfy all obligations under the contract. • The contractor can be expected to perform all contractual obligations. <p>When estimating the final outcome of a contract is impractical, but there is an assurance that no loss will be incurred, the percentage-of-completion method based on a zero-profit margin is used until more precise estimates can be made.</p> <p>The completed-contract method is required when reliable estimates cannot be made.</p>	<p>Revenue is recognized for the sale of services and transactions in the scope of construction contract accounting using the percentage-of-completion method when reliable estimates are available.</p> <p>In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:</p> <ul style="list-style-type: none"> • Total contract revenue can be measured reliably. • It is probable that the economic benefits associated with the contract will flow to the entity. • Both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably. • The contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates. <p>In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:</p> <ul style="list-style-type: none"> • It is probable that the economic benefits associated with the contract will flow to the entity, • The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably. <p>When reliable estimates cannot be made, but there is assurance that no loss will be incurred on a contract, the percentage-of-completion method based on a zero-profit margin is used until more precise estimates can be made.</p> <p>The completed-contract method is prohibited. Rather, when the outcome</p>

New standards	Current U.S. GAAP	Current IFRS
<p>date if the contract is terminated for reasons other than the entity's failure to perform as promised. The right to payment for performance completed to date does not need to be for a fixed amount. The right to payment should be for costs incurred to date plus a reasonable margin.</p> <p><i>Transfer at a point in time</i></p> <p>An entity will recognize revenue at a point in time (when control transfers) if performance obligations in a contract do not meet the criteria for recognition of revenue over time.</p> <p>Determining at what point in time control transfers could require a significant amount of judgment. Indicators that control has transferred to a customer include:</p> <ul style="list-style-type: none"> • The entity has a right to payment for the asset. • The entity transferred legal title to the asset. • The entity transferred physical possession of the asset. • The customer has the significant risk and rewards of ownership. • The customer has accepted the asset. <p>This list is not intended to be a checklist or all-inclusive. In evaluating when control has transferred, no factor is determinative on a stand-alone basis.</p>		<p>of a construction contract cannot be estimated reliably:</p> <ul style="list-style-type: none"> • Revenue is recognized only to the extent of contract costs incurred that it is probable will be recoverable. • Contract costs are recognized as an expense in the period in which they are incurred.
<p>Measuring transfer of control over time</p> <p>A contractor should measure progress toward satisfaction of a performance obligation that is satisfied over time using the method that best depicts the transfer of goods or services to the customer. Methods for measuring progress include:</p> <ul style="list-style-type: none"> • Output methods that recognize revenue based on units produced or delivered, contract milestones, or surveys of work performed. • Input methods that recognize revenue based on costs incurred, labor hours expended, time lapsed, or machine hours used. 	<p>A contractor can use either an input method (for example, cost-to-cost, labor hours, labor cost, machine hours, or material quantities), an output method (for example, physical progress, units produced, units delivered, or contract milestones), or the passage of time to measure progress towards completion at the contract level.</p> <p>Once a "percentage complete" is derived, revenue, cost of revenue, and gross profit are determined using either the revenue or gross profit method.</p>	<p>A contractor can use either an input method (for example, cost-to-cost, labor hours, labor cost, machine hours, or material quantities), an output method (for example, physical progress, units produced, units delivered, or contract milestones), or the passage of time to measure progress towards completion.</p> <p>Once a "percentage complete" is derived, revenue, cost of revenue, and gross profit are determined using the revenue method. Use of the gross profit method is prohibited.</p>

New standards	Current U.S. GAAP	Current IFRS
<p>Output methods such as "units delivered" or "milestones met" may not faithfully depict an entity's performance if, at the end of the reporting period, the value of work-in-progress or finished goods controlled by the customer is material, or if the contract provides both design and production services.</p> <p>The method selected should be applied consistently to similar contracts and in similar circumstances. Once the progress percentage is determined using the selected metric, it is applied to total contract revenue to determine the amount of revenue to be recognized.</p> <p>When using an input method, the effects of any inputs that do not represent the transfer of goods or services to the customer, such as abnormal amounts of wasted materials, should be excluded from the measurement of progress.</p> <p>In some circumstances, it may be appropriate to recognize revenue equal only to the costs incurred if those costs do not represent the entity's progress (such as materials procured by a third party that are not distinct and that the customer controls before the entity provides the related services).</p> <p>An entity should recognize revenue over time only if the entity can reasonably measure its progress towards complete satisfaction of the performance obligation. If an entity cannot reasonably measure its progress, but expects to recover its costs, it should recognize revenue to the extent of costs incurred until it can reasonably measure progress.</p> <p>Estimates to measure progress (for example, estimated cost to complete when using a cost-to-cost calculation) should be regularly evaluated and adjusted using a cumulative catch-up method.</p>		

Impact – both US GAAP and IFRS

A&D entities will need to assess their contracts to determine whether control of the performance obligation being constructed transfers over time to the buyer. Many contracts may have a similar pattern of revenue recognition as under existing guidance. The new guidance contains specific criteria for assessing whether control transfers at a point in time or over time based on the terms of the arrangement.

Government contracts commonly require highly customized engineering and production and the government specifies the design and function of the items being produced. The products and services often have only a single (or limited)

customer base, have long lead procurements that create practical challenges in redirecting goods to other customers and/or require government approval to sell to other customers. Government contracts also commonly require progress or performance payments and include an unconditional obligation to pay in exchange for the government controlling any work in process as it is manufactured.

Many US government contracts have termination for convenience (“T4C”) clauses that provide the entity with an enforceable right to payment for performance completed to date. A T4C clause by itself does not result in government contracts being accounted for over time. Rather, government contracts with T4C clauses often have attributes that indicate that the products have no alternative use, which in conjunction with a T4C clause, meet the criteria to recognize revenue over-time. As a result, many A&D government contracts will likely meet the criteria for transfer of control over time. If contractual provisions are unclear as to whether a right to payment exists, a legal interpretation may be required.

Commercial aerospace contracts also commonly include highly-customized systems and components that are integrated with the aircraft design and are unique to a specific aircraft model. Whether these contracts result in the transfer of goods or services over time will be a matter of judgment depending on the nature of the product, the contract terms, and related facts and circumstances. Certain commercial component or system manufacturers that may have previously recognized revenue on delivery, may need to recognize revenue over time.

The assessment of whether an asset has an alternative use is based on the asset in its completed state and therefore products that include customer-specific customization late in the production life cycle may still qualify for over time recognition. Standard assets that could still be redirected to other contracts might be better presented as inventory since the standard asset remains fungible to use on multiple customers’ orders. Once the asset is incorporated into the customization process, and can no longer be used to satisfy other orders, the entity would ensure it has the right to payment (including a portion of profit) for the asset, and related costs, to determine if over time recognition is required as it would be at this point when control would start to transfer to the customer.

The new revenue guidance allows both input and output methods for recognizing revenue over time. An entity should select the method that best depicts the transfer of control of goods and services. Some contractors have historically used the units-of-delivery or milestone methods to measure progress of completion of a contract. However, under the new standards, these methods would not faithfully depict an entity’s performance in satisfying a performance obligation. This would be the case if at the end of the reporting period the entity’s performance has produced work in process or finished goods controlled by the customer that are not included in the measurement of the output. Accordingly if an entity’s work in process is material (to the contract or to the financial statements as a whole), it will need to use a method other than milestone or units-of-delivery. In practice, we expect most entities who have used these methods historically to transition to a cost-to-cost method going forward.

The gross profit method of calculating revenue, costs of revenue, and gross profit based on the “percent complete” will no longer be acceptable, which is a change from current US GAAP. The gross profit method is already prohibited under current IFRS.

Example 5-1 – Transfer of control – government contract

Facts: A contractor enters into a contract with a government to build an advanced radar and weapons system. The contract has the following characteristics:

- The radar and weapons system is designed to the government's specifications that, due to the proprietary technology used, cannot be transferred to any other government or customer without approval.
- The government makes nonrefundable progress payments to the contractor.
- The government can terminate the contract at any time, but is required to pay for work performed. The government has legal ownership rights in the work in process as it is manufactured; if the contractor terminates the contract, the government gets title to the work in process.
- Physical possession and title do not pass to the government until completion of the contract.

The contractor determined that the contract is a single performance obligation because the contractor is providing a service to integrate all elements of the project into a single item for the government. Also, the contractor determined that given the ownership rights in the work in process, the government controls the work in process.

How should the contractor recognize revenue in this example?

Discussion: The contractor is constructing an asset over the contract term. The contractor will recognize revenue as the performance obligation is satisfied over time, using a measure of progress that best depicts the transfer of control.

Given that the government controls the work in process as the asset is constructed, the contractor will likely use an input measure (e.g., cost-to-cost) to depict transfer of control as the work is performed. It is presumed that an input measure would be used because an output measure would probably not take into account work in process (or inventory) that belongs to the government.

Example 5-2 – Transfer of control – commercial contract

Facts: A manufacturer enters into a contract with a customer to be the exclusive supplier of a certain aerospace system to be used on a commercial aircraft over the life of the aircraft program. The aerospace system is based on the manufacturer's standard design and is customized to the commercial aircraft's requirements. The customer issues purchase orders that obligate the customer to procure a specific quantity of systems. The manufacturer does not produce any contract-specific items in advance of receiving an order; however, it may stock certain standard components that are used across the product line. Since the systems are highly specified, completed systems could not be readily redirected to another customer without significant rework.

- The customer is not required to make progress payments over the period of production. It is anticipated that orders will be fulfilled in 120 days.
- While order quantities are provided in advance, purchase orders are not issued until 120 days from the desired shipment date.
- There are no stated termination provisions in the contract. The manufacturer has determined it has no right to payment.
- Title to the system passes to the customer upon shipment.

How should the manufacturer recognize revenue in this example?

Discussion: We would expect revenue to be recognized at a point in time. The customer does not have physical possession, does not have legal ownership rights through progress or performance payments, and does not take title to the work in process. While the systems have no alternative use, the manufacturer does not have a right to payment.

In assessing the entity's right to payment, the manufacturer would not need right to payment for common inventory until control over the inventory is passed to the customer, which may occur when it is integrated into the customization process. Once performance commences, the entity would assess whether it has an enforceable right to payment for costs incurred to date plus a reasonable profit margin (based on a reasonable portion of the initial expected profit margin or the entity's cost of capital). Since it does not, revenue would be recognized at a point in time (most likely, upon delivery.)

Long-term maintenance contracts

Long-term maintenance contracts are common in the A&D industry. The accounting for such contracts is similar to extended or separately-priced warranties in many instances, which are accounted for as separate performance obligations under the new standards similar to service contracts. Judgment will be needed to determine whether a long-term maintenance arrangement represents a single performance obligation satisfied over time or multiple distinct goods or services, each satisfied when the maintenance event occurs, which could meet the requirements to be accounted for as a single performance obligation under the series guidance.

Contracts to perform an unspecified number of maintenance events over a period of time are likely to result in a single performance obligation satisfied over time. Contracts to perform each maintenance event at a specified price per event are likely to result in separate distinct goods or services for each maintenance activity, which may meet the requirements to be considered a single performance obligation (under the series guidance) if each of the distinct goods or services are satisfied using the over time model, are substantially the same, and have the same pattern of transfer to the customer.

While a single performance obligation may result under either scenario, the treatment of variable consideration and modifications will differ significantly. For example, many modifications to contracts with performance obligations determined through the series guidance are expected to be accounted for as a separate contract. In addition, variable consideration (escalation, incentives, penalties, guarantees, etc.) may be required to be allocated to the distinct goods or services within a series as opposed to the overall performance obligation.

Example 5-3 — Long-term maintenance agreement

Facts: A company enters into a contract to sell an aerospace component system to a customer, and agrees to maintain that system for a period of 10 years once the system is operational. These systems are often sold in the market without the extended maintenance contract. The maintenance contract can also be purchased separately for an additional cost.

How should the company record revenue for this contract?

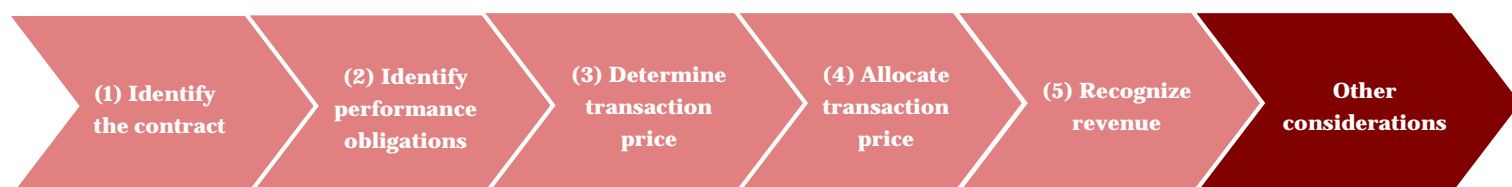
Discussion: There are likely two performance obligations in this contract: one to deliver the aerospace component system and a separate performance obligation for the extended maintenance. The maintenance is a separate performance obligation because 1) it could be purchased separately by the customer and 2) the maintenance and the component system are not inputs to a combined output. The total transaction price should be allocated to the two performance obligations based on their relative standalone selling prices.

The aerospace component system is likely a performance obligation satisfied at a point in time, with revenue recognized when control of the product is transferred to the customer. The maintenance performance obligation is likely satisfied over time, with revenue recognized based on an appropriate measure of progress, which may be a cost-to-cost method if both the entity and the customer expect the service to be performed unevenly over the duration of the contract period.

The standards permit entities to elect a practical expedient to recognize revenue based on amounts invoiced to the customer in certain circumstances. Entities that use a straight-line or right to invoice method will have uneven profit margins on these contracts. Refer to PwC’s guide, *Revenue from contracts with customers*, for more information on the ‘right to invoice’ expedient.

Entities should establish procedures and controls to ensure that costs included in work in process are not controlled by the customer and appropriate procedures are in place to establish accruals and recognize transfer of control for outsourced work in process.

Long-term maintenance contracts will generally be a good or service that transfers to the customer whereas standard warranties will generally remain a cost accrual under existing guarantee and contingency guidance unless the warranty provides the customer with service in addition to assurance that the product meets its specifications. Warranties that are sold separately are separate performance obligations for which revenue is recognized over the warranty period



Other considerations

Contract costs

Existing construction contract guidance contains a substantial amount of cost capitalization guidance, both related to pre-contract costs and costs to fulfill a contract. The new standards substantially supersede much of the cost guidance and includes contract cost guidance that could result in a change in the measurement and recognition of contract costs as compared to today.

New standards	Current US GAAP	Current IFRS
Incremental costs of obtaining a contract are capitalized if the costs are expected to be recovered. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained. As an accounting policy election, such costs can be expensed as incurred if the	There is a significant amount of detailed guidance relating to the accounting for contract costs within the construction contract guidance, particularly pre-contract costs. Pre-contract costs that are incurred for a specific anticipated contract generally may be deferred only if	There is detailed guidance relating to the accounting for contract costs under IAS 11. Costs that relate directly to a contract and are incurred in securing the contract are included as part of contract costs if they can be separately identified, measured

New standards	Current US GAAP	Current IFRS
<p>amortization period is less than one year.</p> <p>Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained are recognized as an expense when incurred (for example, marketing expenses or employees' fixed salaries), unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.</p> <p>Direct costs incurred to fulfill a contract are first assessed to determine if they are in the scope of other standards (for example, those addressing inventory, intangibles, or fixed assets), in which case the entity should account for such costs in accordance with those standards (either capitalize or expense).</p> <p>Costs that are not in the scope of another standard are evaluated under the revenue standards. An entity recognizes an asset only if the costs relate directly to a contract or an anticipated contract, generate or enhance resources of the entity that will be used to satisfy future performance obligations, and are expected to be recovered under the contract.</p> <p>All costs relating to satisfied performance obligations and costs related to inefficiencies (that is, abnormal costs of materials, labor, or other costs to fulfill) are expensed as incurred.</p> <p>Capitalized costs to obtain or fulfill a contract are amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. The amortization period may include specific anticipated contracts (e.g., contract renewals).</p> <p>The asset recognized for the incremental costs of obtaining or the costs fulfilling a contract should be periodically assessed for impairment. An impairment loss is recognized in profit or loss if the carrying amount of the asset exceeds:</p>	<p>their recoverability from that contract is probable.</p> <p>Additionally, certain pre-production costs may only be capitalized if they are contractually guaranteed of recovery if they were accounted for outside of construction contract guidance.</p> <p>Entities may recognize costs based on the average cost per unit, using estimates of total costs over the life of the contract. The average cost method often results in the deferral of contract costs that are subsequently recognized as cost of sales as additional performance takes place under the contract.</p>	<p>reliably, and it is probable that the contract will be obtained.</p> <p>Costs are additionally assessed to see if they fall into the definition of another standard (for example, PP&E, intangibles, or inventory)</p>

New standards	Current US GAAP	Current IFRS
<ul style="list-style-type: none"> the remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less the remaining costs of providing those goods or services. 		

Impact – both US GAAP and IFRS

Under the revenue standards, companies no longer have the option to capitalize costs to obtain a contract. All incremental costs must be capitalized if the company expects to recover the costs, subject to the practical expedient that permits a company to expense incremental costs to obtain a contract when the expected amortization period is one year or less. This guidance could impact A&D entities depending on how they are currently accounting for costs to obtain contracts.

A&D entities that use the average cost method or otherwise defer costs under current US GAAP guidance may be affected by the new standards. Costs in the scope of another asset standard must be accounted for under that standard (which might require capitalization or expensing as incurred). This could result in more items being expensed or capitalized depending on the entity’s existing accounting policy. Entities that previously capitalized or expensed costs associated with anticipated or firm contracts with customers should review the fulfillment guidance to determine if these costs meet the scope requirements to be accounted for as a fulfillment cost and whether they meet the criteria for capitalization. In doing so, the entity may identify certain costs that may be within the scope of other accounting guidance, which may require the costs to be expensed as incurred. If subject to the fulfillment cost guidance in the standards, the capitalization threshold may be lower in certain instances than under previously applied guidance.

An asset recognized for contract costs under the new standards may relate to both a contract and another specific anticipated contract. The asset would then be amortized on a systematic basis that is consistent with the transfer to the customer of the goods or services to which the asset relates. This may ultimately be over a period greater than the initial contract period. Costs attributable to each performance obligation under the contract will generally be expensed as that individual performance obligation is satisfied.

One type of cost common to the A&D industry are learning curve costs. Learning curve costs are costs an entity incurs to provide a service or produce an item in early periods before it has gained experience with the process. Over time, the entity typically becomes more efficient at performing a task or manufacturing a good when done repeatedly and no longer incurs learning curve costs for that task or good. Learning curve costs incurred for a single performance obligation that is satisfied over time are recognized in cost of sales, but they may need to be considered in the measure of progress toward satisfying a performance obligation, depending on the nature of the cost. Learning curve costs incurred for a performance obligation satisfied at a point in time are either capitalized as an asset or expensed as incurred. Learning curve costs should be assessed to determine if they are addressed by other standards (such as inventory). Costs not addressed by other standards are assessed to determine if they meet the criteria for capitalization under the revenue standards.

Application of the standards to “learning curve” costs will require judgment. Certain learning curve costs not in the scope of another asset standard may meet the criteria for capitalization under the new standards, while others may not. Demonstrating that learning costs relate to future performance obligations may be difficult, resulting in some of those costs being expensed as incurred.

Entities may have capitalized costs under current GAAP for certain goods or services provided for free. Under the new standards, free goods or services may be separate performance obligations that require revenue to be allocated to them and recognized when control of the free goods or services are transferred to the customer. In certain situations, there may be no revenue to allocate to free goods or services (e.g., when there are no firm orders with related consideration), which could result in free goods or services being recognized as a loss.

Example 6-1 – Contract costs

Facts: A contractor enters into a contract to design and build a complex aerospace system for an airframer. Performance of the contract is expected to occur over a ten-year period without any anticipated renewals. The contractor utilized a third-party sales agent to help negotiate the contract. The contractor pays the sales agent a one-

time agency fee (commission) upon successful awarding of the contract to the contractor. Additionally, the contractor incurs \$5 million of unfunded contract-specific engineering development costs that are not reimbursed by the airframer.

How should the contractor account for the commission paid to the agent and contract-specific development costs?

Discussion: The new revenue guidance requires incremental costs to acquire a contract to be capitalized and amortized over the related performance period. As a result, the commission paid to the third-party sales agent should be capitalized and amortized over the period of economic benefit (ten years).

The \$5 million of contract-specific development costs would be assessed to determine whether they are a good or service that transfers to the customer. If not a good or service that transfers to the customer (e.g., intellectual property rights may not transfer and another party could not benefit from the work executed to date by the contractor), the contractor would then assess whether the costs were within the scope of the fulfillment cost guidance or research and development cost guidance. If within the scope of the research and development guidance, the costs would be accounted for in accordance with that guidance. If the costs are not within the scope of other guidance, the entity would consider whether they can be capitalized in accordance with the guidance for fulfillment costs.

Example 6-2 – Learning curve costs

Facts: A contractor enters into a contract to manufacture ten aerospace components for a customer that are substantially the same. The contractor determines that each component meets the criteria to be a single performance obligation satisfied over time because any work in process is controlled by the customer. The same method would be used to measure the contractor's progress towards manufacturing each component. This results in the contractor having a series of components with the same pattern of transfer and therefore a single performance obligation satisfied over time. The contractor has concluded that an input measure (cost-to-cost) is the most appropriate measure of progress.

The contractor estimates that each component will cost \$80,000, on average, to manufacture and prices the contract at \$100,000 per component, or \$1 million. The contractor previously developed the required technology to manufacture the aerospace components, but this is its first production contract. The first two components are expected to cost \$95,000 to manufacture due to the learning curve involved.

How should the contractor account for revenue and cost for this contract?

Discussion: The terms of the contract result in the entity having a single performance obligation that is satisfied over time. Using the cost-to-cost method will result in the contractor recognizing more revenue and expense for the first components produced as compared to the later components. This effect is appropriate given that the contractor would likely charge a higher price to a customer purchasing only one unit as compared to the average unit price charged when the customer purchases more than one unit.

If the contractor determines that revenue should be recognized at a point in time (upon delivery of each product), a different conclusion could be reached. The learning curve costs would need to be assessed under other guidance, such as inventory guidance, and if they are not addressed by other standards, they would need to be assessed under the revenue guidance. In circumstances when control of a performance obligation transfers at a point in time, there will likely be varying levels of profit recognized, as the standards do not permit adjustments to achieve average margins in a point in time scenario.

Onerous contracts

Existing guidance for construction contracts under both IFRS and US GAAP require recording anticipated losses when they become evident. This assessment is made at the contract level and measured based on the estimated contract revenue compared with the costs to complete the contract.

The new standards do not include new guidance on accounting for onerous contracts. Under US GAAP, the existing accounting literature (in ASC 605-35) requires an evaluation of whether a loss provision is needed. This onerous contract guidance will continue to be applicable for entities within the scope of ASC 605-35. Entities under US GAAP may make a policy election to measure provisions on onerous contracts at the contract or performance obligation level.

Since IFRS 15 supersedes the accounting guidance for loss-making contracts under IAS 11, IFRS reporters will now account for onerous contracts in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. IFRS requires that the assessment for onerous contracts be performed at the contract level. The policy election provided by US GAAP is not available under IFRS. IFRS guidance also requires entities to consider the least net cost of exit when calculating the onerous contract provision.

Transition

Public entities will apply the new standards in the first interim period within annual reporting periods beginning on or after December 15, 2017 (US GAAP) and January 1, 2018 (IFRS). For nonpublic entities (US GAAP-only), the standard is effective for annual reporting periods beginning after December 15, 2018 and for interim reporting periods within annual reporting periods beginning after December 15, 2019.

Entities may apply the new standards by selecting one of two transition methods: full retrospective or modified retrospective. Full retrospective application requires applying the new standards to each prior reporting period presented. Entities electing the modified retrospective approach will recognize the cumulative effect of initially applying the revenue standards as an adjustment to the opening balance sheet of retained earnings in the period of initial application. Comparative periods are not adjusted under the modified retrospective approach. There are certain practical expedients available under both transition methods and additional disclosures are required when utilizing the modified retrospective approach. Entities should carefully consider the needs of investors and other users of their financial statements when selecting a transition method.

About PwC's Aerospace & Defense practice

Our Aerospace & Defense (A&D) practice provides industry-focused assurance, tax, and advisory services to leading A&D companies around the world. We help A&D companies address a full spectrum of industry-specific challenges. We actively leverage our diverse institutional knowledge, experience, and solutions to provide a fresh perspectives and significant value for our clients.

PwC helps organizations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 223,000 people who are committed to delivering quality in assurance, tax, and advisory services.

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