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Revenue Recognition Proposal to Be Reexposed

In This Issue:

There may be complex implementation challenges ahead as a result of the proposed changes to the revenue recognition model.

The Bottom Line

- The FASB and IASB (the "boards") proposed a single, comprehensive revenue recognition model with the issuance of an exposure draft (ED) in June 2010. The boards received nearly 1,000 comment letters in response to the ED and started redeliberating the proposal in January 2011.
- Aerospace and defense (A&D) companies were one of the most vocal groups to respond to the ED, primarily expressing concern not only that the proposal significantly changes how revenues are recognized but also that its approach to revenue recognition might not reflect the economics of the transactions.
- The boards have been receptive to the input received and have made many tentative decisions that will more closely align the proposed model with the current accounting for long-term contracts. Nevertheless, the proposed rules could still materially affect both revenue and cost recognition for A&D companies.
- A&D companies will need considerable time and resources to implement the new rules, particularly given the anticipated requirement for retrospective application.
- The proposal will be reexposed in the third quarter of 2011 and will have a 120-day comment period. The effective date of the final standard is not likely to be earlier than 2015.

Beyond the Bottom Line

A&D companies should continue to monitor the boards' tentative decisions and prepare to comment on the reexposed ED. In addition, to effectively plan for the significant changes ahead, A&D companies should evaluate the significance of the industry-specific challenges to their businesses and assess the requirements of an eventual implementation. The discussion below provides insight on these and other important considerations related to the proposed changes in revenue recognition for A&D companies.

The proposed model outlines five specific steps for recognizing revenue.

Proposed Changes in Revenue Recognition

Since the issuance of the ED, many A&D companies provided feedback to the boards through comment letters and participation in roundtable meetings. On the basis of the feedback received from many industries, the boards have made significant adjustments to the proposed model — and many of the revisions will be welcomed by A&D companies. Key tentative decisions the boards have made to date regarding the five-step revenue recognition model, contract costs, disclosures, and transition are outlined below.

Identification of the Contract

The first step in the proposed revenue recognition model is identifying the contract. In addition to evaluating whether a contract exists for accounting purposes, A&D companies must assess for accounting purposes whether multiple contracts should be treated as a single contract and whether a contract modification should be treated as a new contract.

Combining Contracts

Although the ED required contracts to be combined or segmented in specific circumstances, the boards tentatively decided to eliminate the contract segmentation requirement. However, they retained the requirement to combine contracts. Accordingly, a company would combine contracts if (1) they are entered into at or near the same time with the same customer (or related customers) and (2) one or more of the following criteria are met:

- The contracts are negotiated as a package with a single commercial objective.
- The amount of consideration in one contract depends on the other contract.
- The goods or services in the contracts are interrelated in terms of design, technology, or function.

While a company would no longer be required to segment a contract, the proposed model would still require segmentation of a contract into performance obligations (i.e., individual units of accounting), which could potentially increase the complexity of applying a revenue recognition model to long-term contracts. See discussion below.

Contract Modifications

Separately, the boards have redeliberated the circumstances in which a contract modification should be accounted for as a separate contract and have tentatively decided that, if a contract modification results in the addition of a performance obligation whose pricing is commensurate with such obligation, the modification should be treated as a separate contract. If the pricing is not commensurate with the additional obligation, the company should reassess all the performance obligations in the contract and reallocate the transaction price to each separate performance obligation.

Contract modifications may create additional units of accounting in the form of either new contracts or separate performance obligations of the original contract. Furthermore, unpriced change orders and claims may not even meet the definition of a contract if they are not considered approved or if enforceable rights have not been established, potentially delaying revenue recognition associated with those items.

Identification of Separate Performance Obligations

The second step in the proposed model requires the separation of the contract into performance obligations. The ED proposed criteria that would have significantly increased the number of units of accounting for long-term contracts. However, the boards tentatively decided that a company should account for a bundle of goods and services as a single performance obligation if the company provides a service of integrating those goods and services into an item that the company delivers to the customer (e.g., providing materials and services to construct a building). In all other cases, a good or service is accounted for as a separate performance obligation if (1) its pattern of transfer is different from that of other promised goods or services and (2) it has a distinct function, meaning it must satisfy at least one of the following criteria:

- The company regularly sells the good or service separately.
- The customer can use the good or service either on its own or together with resources that are readily available to the customer.

The contract itself can no longer be presumed to be an acceptable accounting unit, and the determination of whether separate performance obligations exist may sometimes require companies to exercise considerable judgment. However, the boards have suggested that long-term construction or production-type contracts may often meet the criteria to be accounted for as a single performance obligation.

The identification of separate performance obligations will be a new procedure for A&D companies.

Determining the Transaction Price

The third step in the proposed model requires measurement of the overall amount of consideration to be recognized eventually as revenue.

Variable Consideration

The ED proposed that variable consideration (e.g., penalties, incentives) that can be "reasonably estimated" at a probability-weighted amount be included in the transaction price. However, the boards tentatively decided that variable consideration would be included at either the probability-weighted or the "most likely" amount, whichever is more predictive. In addition, the boards indicated that the recognition of variable consideration would be limited to circumstances in which it is "reasonably assured" that a company would be entitled to that amount.

Careful consideration will be required in the initial determination and ongoing reassessment of when and how variable consideration is included in the transaction price.

Time Value of Money

The ED proposed that the transaction price be adjusted for the time value of money when the financing component is significant to the contract. The boards have tentatively identified factors to be used in making this assessment and have suggested a practical expedient that would make such assessment unnecessary when the period between the transfer of goods or services and payment (and vice versa) is one year or less.

When a contract contains a material financing component, payments in arrears will reduce revenues, and payments in advance will increase revenues.

Collectibility

The ED proposed that the initial transaction price be adjusted for credit risk (and that subsequent adjustments for the actual amount collected from the customer be reflected outside of revenues), which would have reduced the overall amount of contract revenue to recognize. The boards have tentatively decided that both initial and subsequent adjustments for credit risk are not adjustments to the transaction price but rather should be presented in a separate income statement line item as a component of net revenues. In addition, the boards tentatively decided not to specifically include a provision that collectibility be "reasonably assured" as a revenue recognition criterion.

> Revenues and margins will decline as a result of the presentation of bad debt expense as a component of net revenues.

Allocating the Transaction Price

The fourth step in the proposed model requires that companies allocate the transaction price to each separate performance obligation by determining relative stand-alone selling prices, either on the basis of observable data or, alternatively, reasonable estimates. Subsequent changes in the transaction price (e.g., due to variable consideration) would be allocated to all performance obligations in the contract, except when a change in the transaction price relates entirely to one performance obligation. That would be the case if both of the following conditions are met:

- The contingent payment terms of the contract relate specifically to the company's efforts to satisfy that performance obligation or to a specific outcome from satisfying that separate performance obligation.
- The amount allocated (including the change in the transaction price) to that particular performance obligation is reasonable relative to all of the performance obligations and payment terms (including other potential contingent payments) in the contract.

> The determination of stand-alone selling prices, and the evaluation of whether a change in the transaction price relates to a particular performance obligation, will have ramifications on the timing of revenue recognition. Furthermore, complexities may arise in allocating the transaction price among fixed-dollar performance obligations and those priced at "cost plus."

A&D companies should proactively assess whether the terms of their customer arrangements indicate that a continuous transfer of control has occurred.

Recognizing Revenue

The final step in the proposed model requires revenue be recognized when "control" of a good or service transfers to the customer. The boards tentatively decided that the guidance on the sale of goods and the sale of services would be separate, specifying that continuous transfer of control exists for services (and potentially related goods) if (1) the company's performance creates or enhances an asset that the customer controls as the asset is created or enhanced or (2) the company's performance does not create an asset with alternative use to the company and at least one of the following factors can be demonstrated:

- The customer receives a benefit as the company performs each task.
- Another company would not need to reperform the task(s) performed to date if that other company were to fulfill the remaining obligation to the customer.
- The company has a right to payment for performance to date even if the customer could cancel the contract for convenience.

Revenue currently recognized under a percentage-of-completion method may instead be delayed and recognized, in effect, under a completed-contract method if continuous transfer of control cannot be demonstrated on the basis of the parameters above.

The ED proposes that when a continuous transfer of control exists, revenues be recognized as control is transferred and costs be recognized as incurred (unless separately qualifying for capitalization under the ED). Acceptable approaches to measuring a continuous transfer of control are input methods (e.g., cost-to-cost), output methods (e.g., units delivered), and methods based on passage of time. The ED does not specifically require "reasonably dependable estimates" for this purpose. However, the boards have stated their intention to emphasize in the final standard that the method selected should faithfully depict performance on the contract.

Companies will need to assess whether their methods and policies for measuring progress toward completion comply with the new requirements. In particular, companies will need to be prepared to substantiate and disclose why the selected method faithfully depicts the transfer of goods or services.

Contract Costs

The ED proposed specific cost-capitalization guidance pertaining to the costs of both obtaining and fulfilling a contract.

Capitalization of qualifying costs will be required for contracts with an expected duration greater than a year.

Cost of Obtaining a Contract

The ED required that the costs of obtaining a contract (e.g., selling costs) be expensed as incurred. The boards have subsequently reversed course on this point and decided that incremental costs of obtaining a contract should be capitalized (when recoverable); however, capitalization would be elective for contracts with an expected duration of one year or less. Amortization would occur systematically in accordance with the pattern of transfer of goods or services to which the asset relates. The boards agreed that the amortization period for these capitalized costs may extend beyond the period in which the goods or services of an initial contract will be transferred to a customer (e.g., contract renewals, related subsequent sales).

Because capitalization of the incremental costs of obtaining a contract will now be required for long-term contracts, companies will need to carefully evaluate how to identify such costs and determine the method and period over which amortization occurs.

Fulfillment Costs

The ED proposed that if the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition under other guidance, a company would recognize an asset only if:

- The costs relate directly to a contract (e.g., costs of contract management).
- The costs generate or enhance company resources that will be used in satisfying performance obligations in the future.
- The costs are expected to be recovered (e.g., costs of abnormal amounts of wasted materials, labor, or other resources that were not considered in the price of the contract should be recognized as an expense as incurred).

The boards tentatively decided that the ED's scope should continue to include guidance on fulfillment costs and that they would not address these types of costs comprehensively. In addition, the boards tentatively decided that precontract fulfillment costs (e.g., the costs of mobilization, engineering, and design) incurred in anticipation of a contract may also qualify for capitalization. Like contract acquisition costs, capitalization would be elective for contracts with an expected duration of one year or less, and amortization would follow the pattern of transfer of goods or services.

Separately, the boards tentatively decided that the accounting for costs of products manufactured for delivery under long-term production programs would not be within the scope of the revenue recognition project because these costs are related to accounting for inventory and intangible assets. The boards indicated that this issue may be addressed as part of a separate project.

> Companies will need to take a fresh look at their capitalization policies regarding fulfillment costs.

Disclosures

The boards tentatively decided to largely retain the disclosure requirements proposed in the ED, including:

- A summary of the significant judgments made in applying the proposed guidance, particularly regarding determining the transaction price, allocating the transaction price, and recognizing revenue.
- A disaggregation of revenue into categories (e.g., product, geography, type of customer) — several variations may be needed to satisfy the disclosure requirements.
- A reconciliation (i.e., rollforward) of the aggregate balance of contract assets and liabilities, capitalized contract costs, and onerous performance obligations.
- A description of contracts with customers, including the types of performance obligations and when they are settled, related obligations (e.g., returns, refunds, warranties), and significant payment terms.
- A maturity analysis of remaining performance obligations for contracts with an original expected duration of more than one year.

Even regarding disclosures, significantly more judgment will be required.

> The proposal requires companies to make substantially more disclosures than are currently required and will, in some cases, obligate them to provide forward-looking information.

Transition

During redeliberations, the boards unanimously decided against prospective application and tentatively determined that a company would be required to adopt the future revenue standard retrospectively through either:

- A full retrospective application.
- A retrospective application subject to transition relief as follows:
    - A company would not be required to restate contracts that begin and end within the same reporting period.
    - A company would be permitted to use hindsight in estimating variable consideration in the comparative reporting periods.
    - A company would be required to perform the onerous test only as of the effective date unless an onerous contract liability was recognized previously in a comparative period.
    - A company would not be required to disclose the maturity analyses of remaining performance for prior periods.

In addition, the boards tentatively decided that if a company elects any of the above forms of transition relief, it will be required to (1) state which methods of relief have been employed and (2) provide a qualitative assessment of the likely effect of applying those methods.

A final standard may be effective as soon as January 1, 2015, in which case the new rules would be applied, upon adoption, to all revenue recognized on or after January 1, 2013 (for an SEC registrant providing three years of comparative financial statements).

Challenges for A&D Companies

In addition to its technical requirements, many of the proposal's broader implications may present significant challenges to A&D companies. Such challenges include:

- *Addressing changing financial statements* — The timing and amount of revenue recognized in the financial statements may change materially and may affect business contracts linked to financial performance, including debt, compensation, and surety agreements. Deferred taxes and tax positions may also be affected. Furthermore, investor education and additional disclosures may be necessary to clearly explain the changes to the financial statements.
- *Establishing a supporting infrastructure* — Companies may need new processes, controls, and information technology to facilitate the changes in revenue recognition and cost capitalization. This infrastructure will need to not only support the actual accounting but also to streamline the aggregation and validation of key information to meet the expanded disclosure requirements.
- *Applying principles-based accounting* — Many aspects of the proposed rules — from determining whether a contract exists to providing financial statement disclosures — will require estimation and the exercise of a high degree of judgment. Companies will be starting with a clean slate and will need to develop robust policies and procedures to ensure that treatments are applied consistently throughout periods and divisions.
- *Aggregating historical data* — The proposed requirement for retrospective application means that any revenue recognized in the comparative period(s) before the year of adoption would be subject to the new rules. This could involve gathering data and making assessments pertaining to contracts that commenced many years before the effective date of the new rules.

Data, systems, processes, and controls that do not currently exist may be needed to support implementation.

Thinking Ahead

The boards indicated that the revised ED would most likely be issued for public comment in the third quarter of this year and that it would have a 120-day comment period. During this time, the staffs will continue their targeted outreach and will consider whether to hold public roundtables. A&D companies should maintain their active participation in this process. After the comment period, the feedback received will be deliberated by the boards, which could delay issuance of the final revenue recognition standard until September 2012, according to a joint staff paper.

While the exact details of the proposed rules will be subject to ongoing refinement, the broad requirements have become more defined — and there are many things A&D companies can do to begin preparing. Specifically, they can start to identify and evaluate the challenges introduced by the proposed rules, both in terms of adoption demands and broader business impacts. By planning early, A&D companies can more effectively manage what promises to be, for many, a complex and resource-intense implementation.

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