

Aerospace & Defense Spotlight

Converged Revenue Recognition Model Nearly Ready for Liftoff

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The Bottom Line

The proposed revenue model requires management to use greater judgment in recognizing revenue and related costs and may change the timing of revenue recognition from current practice.

- On November 14, 2011, the FASB and IASB (the “boards”) jointly issued their revised exposure draft (ED) *Revenue From Contracts With Customers*. The revised ED proposes a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and would supersede most current revenue recognition guidance. The proposed model requires entities to perform a closer evaluation of long-term contracts to determine whether a contract with a customer exists.
- In addition, on January 4, 2012, the FASB issued a companion proposed ASU for public comment that would codify the revised ED’s amendments.
- Management will be required to use judgment to determine whether contracts with one customer should be combined and treated as a single contract and to identify the number of performance obligations in a contract.
- The manner in which revenue is recognized for long-term contracts may be affected, since entity management will need to assess and demonstrate how control of goods and services is transferred to the customer over time.
- An entity will need to determine whether (1) contract costs should be capitalized and amortized as goods and services are transferred to the customer or (2) such costs should be expensed as incurred.
- To meet the proposed accounting and disclosure requirements, an entity may have to gather information from contracts with customers that is not readily available.
- Comments on the revised ED and the FASB companion proposed ASU are due by March 13, 2012. A final revenue recognition standard is not expected to be issued until later in 2012 and would not be effective earlier than for annual periods beginning on or after January 1, 2015.

Beyond the Bottom Line

This *Aerospace and Defense* Spotlight highlights the implications of the proposed revenue recognition model.

Background

The revised ED states that the goal of the boards' revenue recognition project, which began in 2002, is to "clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs." After receiving nearly 1,000 comment letters and redeliberating almost every aspect of their June 2010 ED, the boards modified the proposed guidance and developed the revised ED (changes from the June 2010 ED are discussed in detail in Deloitte's November 15, 2011, [Heads Up](#)). The revised ED retained the overall model that was originally proposed, which outlined five sequential steps to recognizing revenue:

1. "Identify the contract with a customer."
2. "Identify the separate performance obligations in the contract."
3. "Determine the transaction price."
4. "Allocate the transaction price to the separate performance obligations in the contract."
5. "Recognize revenue when (or as) the entity satisfies a performance obligation."

The revised ED states that the core principle for revenue recognition is that an "entity shall recognize 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." Although the boards did not modify the five steps to applying this principle, they did change how each step is mechanically applied as well as other aspects of the proposed model. For instance, the proposal would require capitalization of certain costs of obtaining and fulfilling a contract and would modify the criteria for recognizing losses on certain onerous performance obligations.

Compared with current revenue recognition guidance, the revised ED requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the proposal's provisions; and (3) assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

The revised ED clarifies the revenue recognition principles and includes additional guidance on certain revenue transactions. Although the effect of the proposals on some entities is expected to be limited, entities operating in the aerospace and defense (A&D) industry that apply long-term contract accounting may face significant accounting and operational challenges as a result of the revised ED. (For a detailed comparison between ASC 605-35¹ (formerly SOP 81-1) and the revised ED, see the [appendix](#).) A number of the proposed changes are discussed below.

Contract Identification

The first step in the revised ED model is to evaluate and determine whether a contract with a customer exists. An entity would consult the specific terms and conditions of an arrangement to determine whether the parties to the arrangement have a supplier-customer relationship or some other relationship (e.g., as collaborators or as partners,

The proposed model will require A&D entities to reassess the accounting for their long-term contracts and determine whether accounting changes will be required.

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

which are outside the scope of the revised ED). For accounting purposes, A&D entities must assess whether (1) multiple contracts should be treated as a single contract and (2) a contract modification should be treated as a new contract or part of an existing contract.

A&D entities would need to consider all relevant facts and circumstances in assessing whether the counterparty meets the definition of a customer and whether the contract is within the scope of the proposed standard. Contracts with customers may be written, oral, or implied and must create enforceable rights and obligations between two or more parties. The existing presumption used by many entities that a contract is a “profit center” or “unit of accounting” may not always apply under the revised ED; A&D entities may need to change their existing policies and processes to ensure that they are applying the new revenue recognition model consistently throughout the organization.

Contract Combination

For long-term contracts, management will be required to use judgment to determine whether to combine contracts if certain criteria are met. The revised ED requires entities to combine contracts entered into at or around the same time with the same customer (or parties related to the customer), if 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 to be paid in one contract depends on the price or performance of the other contract.”
- “The goods or services promised in the contracts (or some goods or services promised in the contracts) are a single **performance obligation**.”

The identification of a contract will be a required first step for A&D entities.

Although entities are permitted by current U.S. GAAP to combine contracts under certain circumstances, the revised ED will require contract combination when the criteria listed above are met. The contract combination requirement will potentially change what entities have deemed to be a “unit of accounting” or “profit center” in the past. While this suggests that there might be fewer overall units of accounting, A&D entities will also have to consider the criteria for identifying separate performance obligations that could increase the units of accounting and potentially change the attribution of revenue from period to period.

Contract Modification

The revised ED requires entities to account for contract modifications as separate contracts if such modifications result in (1) a separate performance obligation that is “distinct” and (2) an additional consideration that reflects the entity’s stand-alone selling price of that separate performance obligation, including any appropriate adjustments.

Contract modifications may create additional units of accounting in the form of either new contracts or separate performance obligations of the original contract. Consequently, entities in the A&D industry will need to evaluate change orders and options to determine the appropriate manner in which the related revenue is recognized.

Identification of Separate Performance Obligations

The revised ED’s principle for identifying separate performance obligations requires that entities “evaluate the goods or services promised in a contract and . . . identify which goods or services (or which bundles of goods or services) are distinct.” Contracts for which “distinct” performance obligations have been identified must be treated as separate units of accounting. The revised ED contains criteria for determining whether goods or services represent distinct performance obligations that should be accounted

for separately. Further, the boards decided that an entity would account for a bundle of goods or services as a single performance obligation if the goods or services are (1) highly interrelated and the entity provides a significant service of integrating them into a combined item or items and (2) significantly modified or customized to fulfill the contract.

A&D entities will need to carefully evaluate bundled arrangements (e.g., development and production or installation services) to determine whether distinct performance obligations exist. Such an evaluation may be challenging given the complex arrangements A&D entities typically enter into. For example, under existing practices, production lots or parts of a contract that were separately accepted are typically individually analyzed for revenue recognition purposes; however, the revised ED may influence this determination and potentially require the identification of more or less performance obligations than had previously been identified.

Thus, the units of account may change for some A&D entities, resulting in changes in the timing of revenue recognition in the financial statements. This may in turn affect business contracts linked to financial performance, including debt, compensation, and surety agreements.

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

Timing of Revenue Recognition

Under current industry practice, A&D entities generally use the percentage-of-completion method to recognize revenue from long-term contracts and progress toward completion is measured on the basis of input or output measures. Under the revised ED, entities would recognize revenue as control of a good or service is transferred to the customer. If the control of goods or services (and therefore satisfaction of the related performance obligation) is transferred over time, an entity would be required to measure the obligation's progress toward completion in a manner that best depicts the transfer of goods or services to the customer. The revised ED provides specific guidance on when the continuous-transfer-of-control model can be applied and on using and applying an output method and an input method for measuring progress toward completion.

However, the revised ED only permits revenue recognition over time when an entity can reasonably measure the progress toward completion. Therefore, when entities cannot reasonably determine the amount of profit, but losses will not be incurred, revenue should be recognized to the extent that costs are incurred.

A&D entities may be required to delay revenue recognition and recognize revenue at a point in time if a continuous transfer of control does not exist. However, in limited circumstances, when A&D entities cannot reasonably measure progress and revenue is being recognized under the completed-contract method, revenue may be accelerated and recognized over the term of the agreement. As a result of the proposed changes, the fluctuations in A&D entities' profit margins, as well as other key performance measures, may be greater than they are currently.

Contract Costs

The revised ED requires capitalization of certain costs associated with obtaining a contract if those costs are incremental and recoverable. The revised ED also requires capitalization of certain costs of fulfilling a contract if all of the following criteria are met and the costs are not covered by other standards:

1. "The costs relate directly to a contract (or a specific anticipated contract)."
2. "The costs generate or enhance resources of the entity that will be used in satisfying performance obligations in the future."
3. "The costs are expected to be recovered."

Amortization of capitalized costs would occur in a manner consistent with the pattern of transfer of the goods or services to which the asset relates and, in certain circumstances, may extend beyond the original contract term with the customer (e.g., when future anticipated contracts or expected renewal periods exist). All capitalized cost assets will be subject to impairment testing if any indicators of impairment exist.

The revised ED includes guidelines for determining how such costs should be capitalized and amortized to the extent that they are not within the scope of other standards. Under the proposed guidance, A&D entities would most likely have to reevaluate contract costs for existing long-term contracts to determine whether certain costs should be capitalized.

As a result, the revised ED may require A&D entities that currently account for long-term contract revenue and related costs under the percentage-of-completion method to change their existing practices. For example, learning curve costs may now need to be capitalized and amortized, which may differ from the methods currently employed by some A&D entities in relation to these costs.

As a result of the revised guidance, A&D entities applying the percentage-of-completion method of accounting will need to evaluate their long-term contracts to determine which costs should be capitalized as well as the manner in which such costs should be amortized.

Example

Entity A enters into a contract with the U.S. government to manufacture a new surveillance system for \$5 million. The government is required to make nonrefundable progress payments throughout the contract term and, in the event of cancellation, is entitled to the intellectual property contained in the work in progress. Entity A estimates that it will incur \$300,000 in learning curve costs for manufacturing the surveillance system.

To account for these costs, A will need to determine whether they are covered by other standards. To the extent that the costs are not covered by other standards, the revised ED may permit capitalization if the costs are directly related to fulfilling the contract and it is probable that the costs will be recovered. This may change the manner in which A had previously treated certain costs, such as start-up and bid or proposal costs. Because this guidance could significantly affect A's financial statements, it will need to be carefully applied.

Onerous Performance Obligations

Under the revised ED, entities that satisfy separate performance obligations in a contract over a period greater than one year must determine whether the lowest costs to satisfy (or settle) those obligations are greater than the transaction price allocated to them. If so, such entities would be required to recognize a liability and corresponding expense for the expected loss. This loss would be updated as of each reporting date and would be reflected in profit or loss.

The revised ED's requirement for entities to perform this assessment at the performance obligation level, which may be different from the unit of accounting used in current practice, may represent a change for some A&D entities and may prompt the development of new policies and procedures for identifying and recognizing onerous performance obligations (as opposed to merely onerous contracts).

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

Presentation and Disclosures

The revised ED would require significantly more extensive disclosures than current revenue standards, including quantitative and qualitative information about contracts and the significant judgments used in applying the guidance to those contracts. Entities should consider how detailed their disclosures need to be to meet the requirements and how much emphasis to place on each disclosure requirement. The required disclosures would include:

- A disaggregation of reported revenue in the “primary categories that depict how the amount, timing, and uncertainty of revenues and cash flows are affected by economic factors.”
- A reconciliation of the beginning and ending balance of contract assets and liabilities.
- Certain information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about onerous obligations (extent and amount of such obligations, the reasons they became onerous, the expected timing to satisfy the liability, and reconciliation of onerous balances).
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition.
- Information about the methods, inputs and assumptions used to determine the transaction price and allocate amounts to performance obligations.
- Information about assets recognized from costs to obtain or fulfill a contract including a reconciliation of the beginning and ending assets (by main category of asset).

Challenges for A&D Companies

Many A&D entities may face significant challenges in applying the revised ED, some of which are discussed below.

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the revised ED’s requirements, including those related to the identification of contracts and performance obligations. It is important for entities to consider how the revised ED specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The revised ED proposes retrospective application, with certain optional practical expedients available to entities at their discretion. Because of the long-term nature of many contracts in the A&D industry, this aspect of the proposal may require entities to gather data and assess contracts that commenced several years before the effective date of the proposed standard.

Systems, Processes, and Controls

The revised ED proposes several new practices and disclosure requirements under which A&D entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. In addition, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls need to be implemented. Given the long-term nature of many A&D customer contracts, entities may need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the proposed rules.

Income Taxes

Tax departments need to assess changes in book revenue recognition methods to prepare for the tax effects. Federal income tax law contains specific rules on certain types of revenue, such as income from long-term contracts and advance payments for goods and services. Those rules often overlap with a taxpayer's financial reporting policies, in which case the taxpayer often applies, as its tax method, the revenue recognition method it uses in maintaining its books and records. Because the proposed guidance may change the amount and timing of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs, the accounting proposed in the revised ED may have cash tax implications or give rise to new book-tax differences that will need to be captured, calculated, and tracked through tax accounting processes and systems.

If a change in a tax accounting method is advantageous or expedient, including circumstances in which the book method has historically been used, the taxpayer will most likely be required to obtain approval from the tax authorities. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs.

Thinking Ahead

Comments on the revised ED and the FASB companion proposed ASU are due by March 13, 2012. A final standard is not expected to be issued until later in 2012, and the boards have tentatively decided that the effective date will be no earlier than for annual periods beginning on or after January 1, 2015 (with a minimum of a one-year deferral for nonpublic entities applying U.S. GAAP). A&D entities should take advantage of these opportunities to carefully examine the revised ED, provide feedback on the proposed model, and begin assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

Appendix — Key Differences Between ASC 605-35 (Formerly SOP 81-1) and the Revenue Recognition Exposure Draft

The table below summarizes key differences between current U.S. GAAP and the FASB's revised revenue recognition ED¹ (issued on November 14, 2011) regarding long-term contracts in the A&D industry. It does not address all possible fact patterns and should be read in conjunction with ASC 605-35² (formerly SOP 81-1³), ASC 912 (formerly an AICPA audit and accounting guide (AAG)⁴), the revised ED, and other relevant guidance.

Current U.S. GAAP	Revised ED	Likely Impact ⁵
<p>Revenue and costs are recognized as progress is made toward completing a contract.</p> <p>The entire contract is the unit of accounting for profit measurement, unless specific criteria are met that allow for combining or segmenting of contracts.</p> <p>The amounts to be recorded in each period are calculated on the basis of the percentage complete and the total estimate-at-complete⁶ (EAC) revenue, cost, and gross margin.</p> <p>Changes in estimates are periodically reviewed and the cumulative effect of a change in estimate is reflected in the period of change. When estimated costs exceed estimated revenues, a provision for the entire loss is immediately recognized.</p> <p>Generally, the time value of money is not considered.</p> <p>Contract costs include all direct costs and allocable indirect costs. Other types of allowable costs may be included in contract costs for government contractors.</p>	<p>The revised ED's core principle is that "an entity shall recognize 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."</p> <p>The revised ED would apply to all contracts with customers except those that are within the scope of certain other Codification topics. Contracts with counterparties that are collaborators or partners, rather than customers (common in certain industries, such as pharmaceuticals and biotechnology, oil and gas, and health care), do not represent contracts with customers and are outside the scope of the revised ED.</p> <p>In applying the provisions of the revised ED to contracts within its scope, an entity would:</p> <ul style="list-style-type: none"> • "Identify the contract with a customer." • "Identify the separate performance obligations in the contract." • "Determine the transaction price." • "Allocate the transaction price to the separate performance obligations in the contract." • "Recognize revenue when (or as) the entity satisfies a performance obligation." 	<p>Regarding identification of the contract, the proposed guidance on combining contracts and dealing with modifications may result in changes from current U.S. GAAP. The identification and separation of performance obligations may lead to a change in the unit of accounting as well as in the timing of revenue recognition. Entities will also need to reconsider the way they account for costs to fulfill and obtain contracts as well as onerous performance obligations.</p> <p>Compared with current U.S. GAAP, the proposed ASU would also require significantly expanded disclosures about revenue recognition.</p>

	Current U.S. GAAP	Revised ED	Likely Impact
Scope	<p>This guidance generally applies to contracts for which the customer provides specifications regarding "the construction of facilities or the production of goods or for the provision of related services." Such products do not include goods manufactured in a standard manufacturing operation.</p> <p>This guidance may also apply to other arrangements, such as federal government contracts (subject to ASC 912) or certain software arrangements (as specified in ASC 605-985⁷). (SOP 81-1, ¶ 11)</p>	<p>This guidance applies to contracts with customers. Arrangements subject to other guidance, such as leases, insurance contracts, guarantees, and certain nonmonetary exchanges, are outside the scope of the revised ED. (revised ED, ¶ 9)</p> <p>Before revenue can be recognized, a contract, as defined in the proposed guidance, must exist. (revised ED, ¶ 12–15)</p>	<p>Contracts previously accounted for under SOP 81-1 are within the scope of the proposed guidance.</p>

¹ FASB Proposed Accounting Standards Update, *Revenue From Contracts With Customers*.

² For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

³ AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

⁴ AICPA Audit and Accounting Guide, *Audits of Federal Government Contractors*.

⁵ The likely impacts are based on the proposed guidance and typical contract terms, as currently written.

⁶ This represents the total estimated amount for the unit of accounting.

⁷ Formerly AICPA Statement of Position 97-2, *Software Revenue Recognition*.

	Current U.S. GAAP	Revised ED	Likely Impact
Determining the Profit Center/Unit of Accounting	The basic presumption is that the contract is the profit center (unit of accounting) for income measurement. (SOP 81-1, ¶ 17 and 34; AAG, ¶ 4.96)	<p>To identify the “contract” for accounting purposes, an entity may have to combine an individual contract with other contract(s) on the basis of specific criteria, including the timing and interrelation of negotiations, the interrelation of pricing, and whether the promised goods or services are considered “distinct.”</p> <p>The identified contract is then analyzed to determine the seller’s performance obligations⁸ to provide distinct goods or services. Performance obligations that are satisfied at different times must be treated as separate units of accounting. (revised ED, ¶ 17, 23, and 27–30)</p>	Entities can no longer assume that the entire contract is an acceptable unit of accounting. Contracts must be analyzed to determine whether combination or segmentation is required. Such an analysis will most likely result in more units of accounting (despite more frequent contract combination).
Combination	Multiple contracts with a single customer may be combined for accounting purposes, depending on certain criteria, including the manner in which the contracts were negotiated and the extent to which the activities are interrelated. (SOP 81-1, ¶ 37)	<p>Step 1: Identify the Contract With a Customer</p> <p>Two or more contracts must be combined to form a single contract for accounting purposes if they are entered into at or around the same time with the same customer (or related parties) and if any of the following criteria are met:</p> <ol style="list-style-type: none"> “The contracts are negotiated as a package with a single commercial objective.” “The amount of consideration . . . in one contract depends on the price or performance of the other contract.” Some or all of the contracted goods or services are a single performance obligation (i.e., they are not distinct). Goods or services are distinct if either of the following criteria is met: <ol style="list-style-type: none"> They are regularly sold separately by the entity. The customer can benefit from them on their own or with other resources that are readily available.⁹ <p>However, significantly modified or customized goods or services are not distinct if they are highly interrelated and the entity is required “to provide a significant service of integrating” them into the combined contracted item(s). (revised ED, ¶ 17 and 27–30)</p>	<p>Contract combination may occur more frequently and will not be optional.</p> <p>Production contracts with multiple customers will not meet the criteria for contract combination.</p>
Production Contracts	Production contracts using the units-of-delivery basis of the percentage-of-completion (POC) method of accounting may be combined if production is concurrent or sequential for identical products (and may be for multiple customers). (SOP 81-1, ¶ 38)		

⁸ A performance obligation is a promise (whether explicit or implicit) to transfer a good or service to the customer. Performance obligations may arise from contractual terms, operation of law, or customary business practices of the seller.

⁹ Readily available resources are goods or services that are sold separately (by the entity or by another entity) or resources that the customer already has obtained.

Current U.S. GAAP		Revised ED	Likely Impact
Segmentation	<p>Segmentation is not required. In general, a contract may be segmented if either of the following criteria is met:</p> <ol style="list-style-type: none"> The segments were separately proposed (in addition to the entire contract) and the aggregate amount of the segment proposals approximated the amount of the total contract proposal. The segments are clearly indicated in the contract and the seller has a significant history of selling the segments individually (with a consistent pricing strategy and gross profit rates differing from the entire project's gross profit rate). The "excess of the sum of the [segment] prices" over the entire contract price "is clearly attributable to cost savings incident to combined performance." (SOP 81-1, ¶ 40–41) 	<p>Step 2: Identify the Separate Performance Obligations in the Contract</p> <p>The identified accounting contract must be segmented into separate performance obligations (to provide distinct goods, services, or bundles thereof) that are satisfied at different times. Goods or services are distinct if either of the following criteria is met:</p> <ol style="list-style-type: none"> They are regularly sold separately by the entity. The customer can benefit from them on their own or with other resources that are readily available. <p>However, significantly modified or customized goods or services are not distinct if they are highly interrelated and the entity is required "to provide a significant service of integrating" them into the combined contracted item(s). (revised ED, ¶ 23 and 27–30)</p>	<p>The likely result is an increase in the number of units of accounting.</p> <p>In a production contract, units that meet the criteria for being distinct must be treated as separate units of accounting to the extent that they are delivered in different accounting periods.</p> <p>Combined development and production contracts will qualify as separate units of accounting if they are considered distinct goods and services.</p>
Production Contracts	For a production contract employing the units-of-delivery method, segments may be assigned to production lots or releases for the purpose of using estimated average unit cost. Production lots or releases may span multiple periods or years. (SOP 81-1, ¶ 42)		To the extent that individual units are considered distinct and are delivered in different accounting periods, units currently accounted for as production lots or releases may be treated as separate units of accounting under the revised ED.
Warranty	A warranty may be segmented if it meets the criteria for segmentation (uncommon). (SOP 81-1, ¶ 40–41)	A warranty must be treated as a separate performance obligation "if a customer has the option to purchase a warranty separately" or if the warranty "provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications." (revised ED, IG11–IG14)	In certain circumstances, a warranty must be treated as a separate unit of accounting.
Option Rights	Entities are generally not required to account for options before their execution.	In a contract with more than one performance obligation, an option right for additional goods or services represents a separate performance obligation if it provides a material right that would not have been otherwise received without entering into the contract. (revised ED, ¶ IG21)	In certain circumstances, an option right must be treated as a separate unit of accounting.
Contract Modifications (Change Orders, Executed Options, and Additions)	An addition to an existing contract (through a change order or other means) is treated as a separate contract if the related good or service is significantly different from the good or service under the original contract, is priced at a significantly different margin, or was negotiated without regard to the original contract. (SOP 81-1, ¶ 64)	<p>A contract modification is treated as a separate contract if it results in the addition of both of the following:</p> <ol style="list-style-type: none"> Distinct good(s) or service(s). "[C]onsideration that reflects the . . . standalone selling price of the good(s) or service(s)."¹⁰ (revised ED, ¶ 21 and BC58) 	An entity will need to evaluate contract modifications under new criteria to determine whether they should be treated as separate contracts.

¹⁰ The price may be adjusted to reflect the particular circumstances of the contract. This may include a discount for selling costs that were not incurred but would not reflect volume or other discounts related to the original contract.

	Current U.S. GAAP	Revised ED	Likely Impact
Revenue Elements	<p>Total revenue is based on the contract price. Estimated revenues may be limited or excluded for certain items, including award fees and other performance incentives, unpriced change orders, and claims.</p> <p>Revenue is allocated among segments on the basis of the relative value of each segment. (SOP 81-1, ¶ 39, 62, and 65–66; AAG, ¶ 3.28–3.29)</p>	<p>Step 3: Determine the Transaction Price</p> <p>Total revenue is based on the contract (transaction) price. Estimated revenues may be excluded for certain items, including unpriced modifications or modifications whose scope is not approved.</p> <p>In general, the transaction price (and changes therein) is allocated to performance obligations on the basis of their relative stand-alone selling prices (which may be estimated if necessary). However, discounts, contingent consideration, and modifications may be exempt from such allocation in certain situations. (revised ED, ¶ 18–19, 53–54, and 71–79)</p>	<p>Total transaction price (EAC revenue) may be higher to the extent that award fees or performance incentives were excluded under current U.S. GAAP (because of the inability to develop a reasonably dependable estimate).</p> <p>Total transaction price (EAC revenue) may be lower to the extent that unpriced change orders and claims were included under current U.S. GAAP and potentially excluded under the revised ED.</p> <p>Revenue recognition may be accelerated or delayed if there are any differences in total transaction price (EAC revenue).</p> <p>See discussion of differences between allocation methods below under Allocation of Revenue.</p>
Cost Incentives, Award Fees, and Other Performance Incentives	<p>Estimated cost incentives are included in EAC revenue and therefore affect current results.</p> <p>Award fees and other performance incentives are included in EAC revenue to the extent that a reasonably dependable estimate can be made. (AAG, ¶ 3.28–3.29)</p>		
Unpriced Change Orders	<p>Unpriced change orders are included in contract costs as incurred. Revenue is adjusted on the basis of the likelihood of cost recovery through an increase in price:</p> <p>a. If cost recovery is probable, “revenue should be recognized to the extent of the costs incurred.”¹¹ Revenue may be recognized in excess of costs incurred if the amount can be reasonably estimated and assured beyond a reasonable doubt.</p> <p>b. If cost recovery is not probable, revenue is not adjusted. (SOP 81-1, ¶ 62)</p>	<p>Transaction price includes an estimate for unpriced change orders when the entity expects the price to be approved. (revised ED, ¶ 19)</p>	<p>Revenue recognition related to unpriced change orders may be delayed to the extent that an entity does not expect the price to be approved. There is still no specific guidance on determining when this criterion has been met.</p>
Claims¹²	<p>Claims-related contract revenues may be adjusted up to the amount of costs incurred if such amounts are probable and can be reliably estimated in accordance with specific criteria, including legal basis, ability to identify costs, and quality of evidence.¹³ (SOP 81-1, ¶ 65–66)</p>	<p>Claims would be considered unapproved modifications and no consideration would be included in the transaction price. (revised ED, ¶ 18)</p>	<p>Revenue recognition related to claims may be delayed.</p>
Time Value of Money	<p>Generally, the time value of money is not considered.</p>	<p>The time value of money should be reflected in the promised consideration when it is significant to the contract. The interest rate used should reflect a hypothetical financing-only transaction between the entity and the customer. Upon recognition, the adjustment to revenue for the effect of financing is shown separately from revenue for goods or services.</p> <p>This calculation is not required if, at contract inception, the expected time between substantially all payment and the transfer of the promised goods and services is one year or less. (revised ED ¶ 58–62)</p>	<p>Companies will need to assess whether the time value of money is material and may need to adjust total revenue and recognize interest income or expense. The impact could be reflected as income in one period and expense in another, depending on the timing of cash flows and measurement of performance obligations (e.g., progress or milestone payments, existence of warranty).</p>

¹¹ Alternatively, costs may be deferred (excluded from contract costs), with no adjustment to revenue.

¹² Claims are amounts in excess of (or not included in) the agreed-upon contract price that the seller seeks to collect from the customer or others for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved regarding both scope and price, or other causes of unanticipated additional costs.

¹³ A seller may adopt an accounting policy of adjusting claim revenues only when received.

Current U.S. GAAP		Revised ED	Likely Impact
Allocation of Revenue	Revenue is allocated among segments on the basis of the relative value of each segment. In general, significant estimation of value is not required because segmentation is only allowed when the segments have been separately proposed or when the entity has a significant history of selling the segments separately. (SOP 81-1, ¶ 39)	<p>Step 4: Allocate the Transaction Price to the Separate Performance Obligations in the Contract</p> <p>The transaction price (and changes therein) is allocated to performance obligations on the basis of their relative stand-alone selling prices (which may be estimated if necessary).¹⁴ As discussed below, in certain circumstances, exceptions may apply to the following:</p> <ul style="list-style-type: none"> • Discounts. • Contingent consideration. • Modifications. (revised ED, ¶ 20, 71–79) 	<p>For a contract with differing fee types (e.g., cost-reimbursable and fixed-price performance obligations), an entity will need to assess the stand-alone selling prices on a comparable (fixed price) basis. This could result in higher-margin application to cost-reimbursable work at contract inception.</p> <p>In certain circumstances, the method for allocating the transaction price may yield results that are not considered representative of the underlying economics, including:</p> <ul style="list-style-type: none"> • Contracts containing performance obligations of mixed fee types. • Discounts and contingent consideration that relate to specific performance obligations but that do not meet the criteria for allocation to those obligations.
Discounts		A discount is allocated to one or more performance obligations if (1) each good or service (or bundle thereof) is regularly sold on a stand-alone basis and (2) the observable selling prices associated with those stand-alone sales constitute evidence of the performance obligation(s) to which the entire discount relates. (revised ED, ¶ 74–75)	
Contingent Consideration		A transaction price that is contingent on a future event is allocated entirely to one or more performance obligations if (1) the contingency relates specifically to the entity's efforts to satisfy that performance obligation (or a specific outcome resulting from it) and (2) the resulting allocation reflects the amount to which the entity expects to be entitled for satisfying each performance obligation in the contract. (revised ED, ¶ 70 and 76)	
Modifications	Transaction price adjustments are accounted for within the related segment(s).	<p>A transaction price adjustment related to a modification (that is not treated as a separate contract and is more than just a modification to the transaction price) is allocated to all remaining (including partially unsatisfied) performance obligations. No adjustment is made to performance obligations "that are completely satisfied on or before the date of the contract modification."</p> <p>A modification to transaction price only is allocated entirely to one or more performance obligations if the modification (1) relates specifically to the entity's efforts to satisfy a specific performance obligation (or a specific outcome resulting from it) and (2) the resulting allocation to each performance obligation in the contract reflects the amount to which the entity expects to be entitled for satisfying each one. (revised ED, ¶ 20, 22, 76, and 79)</p>	<p>An entity will be required to perform additional analysis of contract modifications to determine how to allocate changes in transaction price.</p> <p>In certain circumstances, an entity that is required to allocate additional revenue among all performance obligations may record reduced margin rates (including a loss) for cost-reimbursable performance obligations whose cost and revenues have increased.</p>

¹⁴ The stand-alone selling price is the price at which an entity would sell a promised good or service separately. If estimation is required, an entity should maximize the use of observable inputs.

	Current U.S. GAAP	Revised ED	Likely Impact
Option Rights	Entities are generally not required to account for options before their execution.	If an option right gives rise to a separate performance obligation, an estimate of the stand-alone selling price should include adjustments for (1) "[a]ny discount that the customer could receive without exercising the option" and (2) "[t]he likelihood that the option will be exercised." (revised ED, ¶ IG23)	In certain instances, the transaction price must be allocated to option rights and, to that extent, may result in the delay of revenue recognition.
Cost Elements	Contract costs include all direct costs (e.g., materials, labor) and allocable indirect costs (e.g., insurance, depreciation). Other types of allowable costs ¹⁵ may be included in contract costs for government contractors. (SOP 81-1, ¶ 39 and 72; AAG, ¶ 3.04–3.06)	Costs of fulfilling a contract are capitalized (included in contract costs) if they meet the requirements in other standards (e.g., inventory). Costs may be otherwise capitalized if they relate directly to a current or specific anticipated contract, "generate or enhance resources of the entity that will be used in satisfying performance obligations in the future," and "are expected to be recovered." Such costs would include "amounts that are explicitly chargeable to the customer." The following costs must be expensed as incurred: a. General and administrative (G&A) costs that are not explicitly chargeable to the customer. b. "Costs of wasted materials, labor, or other resources . . . that were not reflected in the price of the contract." c. Costs that relate to or cannot be distinguished from past performance obligations. (revised ED, ¶ 91–93)	For existing production contracts accounted for as production lots or releases (or units of delivery with average cost), a lower margin may be recognized in early periods (and a higher margin in later periods), depending on the nature of learning curve costs and whether units are considered distinct (i.e., the number of identified performance obligations).
Precontract Costs	Precontract start-up costs are typically expensed as incurred. Other precontract costs may be capitalized ¹⁶ in the following instances: a. Costs are incurred for assets, such as materials, equipment, or creation of inventory, and "their recovery from future contract revenue or from other dispositions of the assets is probable." b. Costs are incurred for a specific anticipated contract (and will result in no future benefits unless the contract is obtained) and their recoverability from that contract is probable. (SOP 81-1, ¶ 75)		
Learning Costs	Learning or start-up costs related to existing contracts "and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts." (SOP 81-1, ¶ 75)		
Costs of Obtaining a Contract	Selling costs are expensed as incurred, "unless they meet the criteria for precontract costs." (SOP 81-1, ¶ 72)	Incremental costs of obtaining a contract, which are defined as costs that the entity "would not have incurred if the contract had not been obtained" (e.g., sales commissions), are capitalized. Otherwise, such costs are expensed as incurred unless they are explicitly chargeable to the customer. Capitalized costs are then "amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates." As a practical expedient, costs of obtaining a contract can be expensed as incurred if the amortization period is less than a year. (revised ED, ¶ 94–98)	Certain costs of obtaining a contract may need to be capitalized and amortized.

¹⁵ As defined by federal procurement regulations.

¹⁶ Noninventory costs are classified outside of the inventory or contract cost classification until the contract is received. Costs previously expensed are not reinstated upon receipt of the contract.

	Current U.S. GAAP	Revised ED	Likely Impact
G&A Expenses	<p>Generally, G&A costs are expensed as incurred and are not included in contract costs, except:</p> <ol style="list-style-type: none"> To the extent considered allowable costs¹⁷ for government contracts. To the extent reimbursable under cost-type government contracts. As allowed for contracts accounted for under the completed-contract method. If included in contract costs, G&A expenses may be expensed as incurred or included in inventory. (SOP 81-1, ¶ 69–72; AAG, ¶ 3.04–3.07 and 3.61–3.62) 	<p>In general, G&A costs are expensed as incurred unless they are explicitly chargeable to the customer. (revised ED, ¶ 91–93)</p>	<p>Government contractors will no longer be allowed to capitalize G&A costs unless they are explicitly chargeable under the contract (e.g., cost-type contracts).</p>
Timing of Revenue/Cost Recognition	<p>In general, revenues and costs are recognized on the basis of the percentage of the contract that is complete as well as the total EAC revenue, cost, and gross margin. Revenues and costs are typically calculated under one of two alternative methods:</p> <p>Alternative A¹⁸</p> <ul style="list-style-type: none"> Incurred-to-date (ITD) revenue = EAC revenue × % complete. ITD cost = EAC cost × % complete. <p>Alternative B</p> <ul style="list-style-type: none"> ITD margin = EAC margin × % complete. ITD cost = Actual costs incurred.¹⁹ <p>Other calculations are required when reasonably dependable estimates cannot be made and when a loss is anticipated. (SOP 81-1, ¶ 25 and 79–81; AAG, ¶ 3.19)</p>	<p>Step 5: Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation</p> <p>Revenue and costs are recognized upon satisfaction of performance obligations. This occurs when the customer obtains control of the promised goods or services.²⁰ Indicators of the transfer of control include (but are not limited to) the present right to payment, transfer of legal title, physical possession, significant risks and rewards of ownership, and customer acceptance.</p> <p>Revenue recognition on an incomplete good or service (percentage-of-completion accounting) is only appropriate when control transfers over time, as defined. In this instance, the following calculation is performed:</p> <ul style="list-style-type: none"> ITD revenue = Allocated transaction price × % complete. <p>Other calculations are required when a reasonable measure of progress cannot be made and may be required when (1) the transaction price includes variable consideration or (2) when a loss is expected. (revised ED, ¶ 31–32, 35, 37, 48, 81–84, and 86–88)</p>	<p>An entity must analyze performance obligations to determine when control is transferred (and therefore when revenue can be recognized). It is likely that fewer contracts will qualify for revenue recognition during the construction period.</p> <p>For production contracts for which the units-of-delivery method is currently used, the timing of revenue recognition may not be significantly different. For other contracts, the timing of revenue recognition may be significantly later to the extent that the transfer of control is not over time.²¹</p> <p>It may no longer be acceptable for entities to recognize revenue under the Alternative B method (allowed under SOP 81-1).</p> <p>ITD costs will be based on the cost of the transferred goods or services.</p>

¹⁷ See footnote 16.

¹⁸ A modification of this method allows for revenue and cost to be recorded on the basis of stated unit prices, actual unit cost, or both, if the units-of-delivery method is used. Under the units-of-delivery method, percentage complete is calculated on the basis of the number of units delivered compared with the total units to be delivered.

¹⁹ Costs incurred are adjusted to exclude materials that are not unique to the contract and subcontractor costs for work yet to be performed.

²⁰ Control refers to the ability to direct the use of and obtain substantially all of the remaining benefits of the asset. Benefits are the potential direct or indirect cash flows that may be obtained from using the asset (e.g., to produce goods or provide services, enhance the value of other assets, settle liabilities or reduce expenses, make a sale or exchange, pledge as security for a loan).

²¹ Under any scenario, the amount of revenue to be recognized in any period may be different depending on the impact of the segmentation criteria discussed above.

	Current U.S. GAAP	Revised ED	Likely Impact
Requirements for Percentage-of-Completion Accounting	To use percentage-of-completion accounting, the seller must be able to make reasonably dependable estimates. Estimates of total contract revenue and costs are considered reasonably dependable if minimum total revenue and maximum total cost can be estimated with enough confidence to justify the seller's bid. (SOP 81-1, ¶ 23 and 27)	Satisfaction of an obligation over time occurs if at least one of the following two criteria is met: a. "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced." b. "The entity's performance does not create an asset with an alternative use to the entity [e.g., inability to transfer to another customer] and at least one of the following is met: i. The customer simultaneously receives and consumes the benefits . . . as the entity performs ii. Another entity would not need to substantially reperform the work . . . to date if that other entity were to fulfill the remaining obligation" ²² iii. The entity has a right to payment for performance completed to date." ²³ (revised ED, ¶ 35)	Fewer contracts/performance obligations will qualify for revenue recognition during the performance or construction period.
Methods of Measuring Progress	The percentage complete may be measured in terms of input or output measures (i.e., amounts expended or completed compared with total estimated input or output). Various methods are allowed, provided that the measure is reasonably related to actual progress toward completion. (SOP 81-1, ¶ 44–51)	Progress should be measured by using a method that depicts the transfer of goods or services. Input or output measures may be used. ²⁴ Output methods may often be the most faithful depiction of an entity's performance. (revised ED, ¶ 38, 41, and BC120)	Output methods may often be the preferred method for depicting the transfer of control of a good or service.
Adjustments to Input and Output Measures	When using a cost-incurred input measure, an entity should disregard certain costs that do not relate to performance (e.g., significant uninstalled materials). (SOP 81-1, ¶ 50)	Percentage-of-completion calculations exclude the following: a. Goods or services for which the entity does not transfer control to the customer. b. For input measures, (1) wasted materials, labor, or other resources not reflected in the price of the contract and (2) significant material procurement in advance of the related efforts (in certain instances, these costs may require recognition at zero margin). (revised ED, ¶ 39 and 45–46)	Cost-to-cost and other input methods must be modified to exclude the effects of cost overruns/underruns that do not result in the transfer of additional/reduced assets to the customer. Output methods (e.g., milestones) may need to be adjusted to exclude goods or services that are not transferred to the customer. There is still no specific guidance on determining which inefficiencies, including waste materials or labor, should be considered "not reflected in the price of the contract" (and should therefore be excluded from the percentage-of-completion calculation). In some instances, significant material procurement, in advance of related efforts, will be recorded as cost of sales at zero margin (as opposed to being capitalized or excluded from the percentage-of-completion calculation).

²² In evaluation of this criterion, it is assumed that another entity would not have the benefit of any asset (e.g., work in process) currently controlled by the entity. Practical or contractual limitations of transfer are ignored.

²³ Compensation for performance completed to date includes payment that approximates the selling price of the goods or services transferred to date (e.g., cost plus a reasonable profit margin), rather than compensation only for loss of profit

²⁴ One method is chosen per performance obligation and must be applied consistently in similar circumstances.

	Current U.S. GAAP	Revised ED	Likely Impact
Provision for Anticipated Losses/Onerous Performance Obligations	When estimated costs exceed estimated revenues, a provision for the entire loss is immediately recognized. The amount should include all elements of contract costs and is recorded as additional contract cost. (SOP 81-1, ¶ 85–88)	When the lowest cost of settling a performance obligation exceeds the transaction price (“onerous performance obligation”), an entity should record a liability if it expects, at contract inception, to satisfy the obligation over time (and over a period greater than one year). The lowest cost may be the amount that would be paid to exit the obligation, if the entity is permitted to do so. Before recording a liability, an entity must test contract assets (e.g., inventory) for impairment. (revised ED, ¶ 86–88)	The recorded liability for a loss-making unit of accounting (onerous performance obligation) may be lower if the costs to exit the obligation are less than the costs of satisfying the obligation. A loss provision will not be recorded if a performance obligation is considered to be satisfied at a point in time (e.g., future delivery of a good when control is transferred upon delivery). Any portion of a loss that must be first recorded as an asset impairment may not be reversed.
Recognition Constraint on Variable Consideration, Including Award Fees and Incentives	The amount of revenue recognized to date (ITD revenue) is constrained only to the extent that it does not qualify for inclusion in the contract EAC.	Total contract revenue recognized to date, including variable consideration that qualifies for inclusion in the estimated transaction price, is capped at the “amount to which the entity is reasonably assured to be entitled.” For estimates of variable consideration, an entity is reasonably assured of being entitled to the amount if it (1) “has experience with similar performance obligations” (or other evidence) and (2) that experience is predictive of the outcome. Indicators that the experience (or other evidence) is not predictive of the outcome include the following: a. “The amount of consideration is highly susceptible to factors outside the entity’s influence” (e.g., judgment of third parties, weather conditions). b. “The uncertainty . . . is not expected to be resolved for a long period of time.” c. The extent of “experience (or other evidence) . . . is limited.” d. Existence of a large number and broad range of possible outcomes. (revised ED, ¶ 81–84)	An entity must monitor total contract revenue recognized to date (ITD revenue), including variable consideration that qualifies for inclusion in the estimated transaction price (EAC revenue), to ensure that it does not exceed the amount of consideration that is reasonably assured.

Presentation and Disclosure Requirements Under the Revised ED	
Presentation	How an entity should present a contract asset or liability depends on the timing of the entity’s performance in relation to the customer’s performance. The entity may use descriptions other than “contract asset” or “contract liability” for these terms. (revised ED, ¶ 104 and 107)
Contract Assets	An entity should present an amount as a contract asset when the entity has transferred goods or services to a customer before receiving the related consideration (or the unconditional right to consideration). ²⁵ Contract assets do not include unconditional rights to consideration or inventoried costs, which are presented separately. (revised ED, ¶ 106)
Contract Liabilities	An entity should present an amount as a contract liability when the entity has received consideration (or the unconditional right to consideration) before goods or services are transferred to the customer. Contract liabilities do not include liabilities recognized for onerous performance obligations, which are presented separately. (revised ED, ¶ 105 and 108)
Progress Payments — Potential Impact	An outstanding billed or billable progress payment (or advance) that has not been earned may be recorded as a receivable and a contract liability. (revised ED, ¶ 1G74)

²⁵ A right to consideration (i.e., receivable) is unconditional when nothing other than the passage of time is required before payment of consideration is due.

Presentation and Disclosure Requirements Under the Revised ED	
Disclosure	<p>The disclosure requirements outlined in the revised ED are more detailed than the current requirements under SOP 81-1 and other industry guidance for government contractors.</p> <p>An entity must determine the appropriate level of detail to provide; the objective is to help users understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. (revised ED, ¶ 109–110)</p>
Disaggregation of Revenue	<p>Revenue must be disaggregated into categories on the basis of the impact of economic factors on the amount, timing, and uncertainty of revenues. Sample categories include major product line, geography, market or type of customer, contract type, duration, and timing of recognition. (revised ED, ¶ 114–115)</p>
Tabular Reconciliation of Contract Balances	<p>The reconciliation must show (on an aggregate basis) a reconciliation of contract assets and liabilities. At a minimum, the following must be disclosed (as applicable):</p> <ol style="list-style-type: none"> Revenue (from satisfied performance obligations). Revenue associated with the reallocation of the transaction price to previously satisfied performance obligations. Cash received. Amounts transferred to receivables. Noncash consideration received. Effects of business combinations. (revised ED, ¶ 117)
Performance Obligations	<p>Disclosures must contain information about performance obligations, including:</p> <ol style="list-style-type: none"> Timing of satisfaction of performance obligations (e.g., upon shipment). Significant payment terms, including variable consideration and material financing components. Goods or services to be transferred. Obligations for returns, refunds, and other similar obligations. Types of warranties and related obligations. For contracts with an original expected duration of more than one year, the amount of the transaction price allocated to remaining performance obligations and an explanation of when recognition is expected to occur (by using time bands or qualitative information). (revised ED, ¶ 118–120)
Onerous Performance Obligations	<p>For onerous performance obligations, an entity must disclose the following:</p> <ol style="list-style-type: none"> Liability recognized. Nature and amount of the remaining performance obligations. Reasons why the performance obligation or obligations are “onerous.” Expected timing of satisfaction of the liability. Tabular reconciliation of the opening to closing balance of the liability recognized. At a minimum, the reconciliation must show the effects of the following during the period (as applicable): <ol style="list-style-type: none"> Performance obligations that became onerous. Liabilities satisfied. Changes in the measurement of the liability. (revised ED, ¶ 122–123)
Tabular Reconciliation of Capitalized Costs to Obtain or Fulfill Contracts	<p>The reconciliation must be presented by major category (e.g., cost to obtain a contract, precontract costs, setup costs) and should include the following, at a minimum (as applicable):</p> <ol style="list-style-type: none"> Additions. Amortization. Impairment losses. <p>A description of the amortization method is also required. (revised ED, ¶ 128–129)</p>
Other Disclosures	<p>Other required disclosures include the following:</p> <ol style="list-style-type: none"> Significant judgments used in determining the timing of satisfaction of performance obligations, including methods used (e.g., input or output methods). Methods, inputs, and assumptions used to determine the transaction price, estimate stand-alone selling prices, measure obligations for returns and refunds (and other similar obligations), and measure the liability for onerous performance obligations. (revised ED, ¶ 124–126)

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