Deloitte.

September 2014

Aerospace & Defense Spotlight

The Converged Revenue Recognition Model Has Landed

In This Issue:

- Background
- Key Accounting Issues
- Effective Date and Transition
- Challenges for A&D Entities
- Thinking Ahead
- Appendix — Key Differences Between ASC 605-35 (Formerly SOP 81-1) and the ASU

The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes ASC 605-35 and most other current revenue recognition guidance (including other industry-specific guidance).

The Bottom Line

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued as ASU 2014-09[1] by the FASB and as IFRS 15[2] by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes ASC 605-35[3] (formerly SOP 81-1[4]) and most other current revenue recognition guidance (including other industry-specific guidance).
- The new standard requires management to use judgment to (1) determine whether contracts with one customer (or related parties) should be combined and treated as a single contract, (2) identify the number of performance obligations in a contract, and (3) determine the transaction price.
- Revenue from contracts for customized goods that an entity creates by providing a "service" to a customer (i.e., the goods have no alternative use to the entity and the entity has a right to payment for performance to date) will need to be recognized over time as the goods are constructed.
- The manner in which revenue is recognized for long-term contracts may be affected, since management will need to assess and demonstrate how control of goods and services is transferred to the customer over time.
- Entities will need to determine whether contract costs should be capitalized and amortized as the related revenue is recognized or whether such costs should be expensed as incurred.
- The new standard requires significantly more extensive disclosures than current guidance; therefore, aerospace and defense (A&D) entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers*.
[2] IFRS 15, *Revenue From Contracts With Customers*.
[3] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."
[4] AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

Beyond the Bottom Line

This *Aerospace & Defense Spotlight* discusses the new revenue model and highlights key accounting issues and potential challenges for A&D entities that recognize revenue under U.S. GAAP or IFRSs. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Background

The goal of the ASU is to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs by (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing "a more robust framework for addressing revenue issues"; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The ASU 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."

Under the ASU, entities must perform the following five steps in recognizing revenue:

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

Entities must reassess their current revenue accounting and determine whether changes are necessary.

Entities must also reassess their current revenue accounting and determine whether changes are necessary. In addition, the ASU 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 revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

A&D entities may encounter accounting and operational challenges in applying the ASU. Some of these key accounting issues are discussed below (for a more detailed comparison between ASC 605-35 and the ASU, see the appendix below).

Identify the Contract(s) With a Customer (Step 1)

Contracts with customers may be written, oral, or implied and must create enforceable rights and obligations between two or more parties. Further, for a contract to exist, management must conclude that it is probable that the entity will collect the consideration to which it expects to be entitled. In evaluating whether a contract with a customer exists, an entity would analyze 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 with other developers that may be outside the ASU's scope). The entity would consider all relevant facts and circumstances in assessing whether the counterparty to a contract is within the scope of the ASU (or another Codification topic).

If a contract with a customer does not meet the criteria to be accounted for under the ASU, the entity would recognize consideration received under the contract as revenue only when (1) the entity has no remaining obligations to transfer goods or services to the customer (because of complete fulfillment or cancellation of the contract), (2) the entity has collected all promised consideration, and (3) the consideration received is nonrefundable.

Contract Combination

Entities must also assess whether to account for multiple contracts as a single contract. The ASU 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 each of the contracts) are a single performance obligation."

Thinking It Through

Unlike current U.S. GAAP, under which A&D entities may consider combining contracts in certain circumstances, the ASU **requires** contract combination when the above criteria are met. A&D entities may enter into multiple contracts with the same customer around the same time but may deem each contract to be the unit of account or profit center and may not have specific procedures in place to evaluate whether those contracts are interdependent. After establishing controls to ensure that this evaluation is performed, A&D entities may need to use judgment to determine whether the ASU's contract-combination criteria are met. A conclusion that the criteria are met could significantly affect when revenue is ultimately recognized. Note that contracts with different customers (that are not related parties) would not be combined.

Under the ASU, contract modifications are treated as a separate contract if the modifications result in the addition of a "distinct" performance obligation and a change in consideration that reflects the entity's stand-alone selling price for such obligations.

Example

An entity enters into two separate contracts: one to design a prototype satellite system for the government and a second to build the satellite system. The contracts for both projects are signed on the same day with the same customer. In this case, the entity would need to consider whether these activities meet any of the contract-combination criteria noted above. If so, the contracts would be accounted for together as a single contract under the ASU. Therefore, instead of treating each contract as a separate unit of account, the entity would evaluate the obligations in the combined contract under the separation criteria in the ASU to determine whether there is a single or multiple performance obligations, which could affect the timing of the entity's revenue recognition and its profit margin (see Identify the Performance Obligations in a Contract (Step 2) below).

Contract Modifications

Under the ASU, contract modifications are treated as a separate contract if the modifications result in (1) the addition of a "distinct" performance obligation (or obligations) and (2) a change in consideration that reflects the entity's stand-alone selling price for such an obligation (or obligations). For contract modifications that do not meet the criteria to be accounted for as a separate contract, an entity must determine whether to account for the modification (1) as a termination of the original contract and the creation of a new contract (i.e., allocate the amount of consideration not yet recognized to the remaining performance obligations) or (2) as if it were part of the original contract (i.e., update the transaction price, measure the progress toward complete satisfaction of the performance obligation, and record a cumulative catch-up adjustment to revenue). The ASU provides specific guidance on making this determination. Depending on how revenue is being recognized (i.e., over time or at a point in time as discussed in Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation (Step 5) below) and the terms of a contract modification, the impact on current and ongoing revenue can differ dramatically. Entities will need to understand this guidance and ensure controls are in place to appropriately apply it as modifications occur.

Thinking It Through

Contract modifications are common in the A&D industry and may create additional units of account in the form of either separate contracts or separate performance obligations associated with the original contract. Under current U.S. GAAP, A&D entities have established practices related to the accounting for approved and unapproved change orders and claims. Entities often seek price adjustments for changes in scope or cost for various reasons. Under the ASU, before recognizing any related revenue for the change, an entity needs to ensure that (1) the customer has approved any change in scope or price or (2) it has enforceable rights to consideration based on an assessment of the legal basis of its claim. If an entity concludes that it has met one of these conditions, the entity would apply the ASU's modification guidance. Consequently, A&D entities will need to evaluate change orders and claims to determine how the related revenue should be recognized.

Identify the Performance Obligations in a Contract (Step 2)

As mentioned above, the ASU supersedes ASC 605-35, including its segmentation guidance. Instead, the ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations." Specifically, the ASU requires an entity to account for a "distinct" good or service (or bundle of goods or services) or a series of distinct goods or services (if they are substantially the same and have the same pattern of transfer) as a performance obligation (i.e., a separate unit of account). The ASU defines a distinct good or service as one that meets both of the following criteria:

- "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 (that is, the good or service is capable of being distinct)."
- "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)."

The ASU requires entities to evaluate the goods and services promised in a contract to identify "performance obligations."

A good or service that does not meet these criteria would be combined with other goods or services in the contract until the criteria are met. While the first criterion is generally consistent with the current guidance in ASC 605-25 on determining whether a good or service has stand-alone value, the second criterion is a new concept. The ASU provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:

- "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract . . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
- "The good or service does not significantly modify or customize another good or service promised in the contract."
- "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

Thinking It Through

Arrangements in the A&D industry often involve a significant service of integrating goods or services into a bundle. However, A&D entities will need to closely evaluate all of their bundled arrangements (e.g., ones that include multiple services such as engineering, procurement, and production services) to determine whether distinct performance obligations exist.

Further, many A&D entities operate under the presumption that a contract is the "profit center" or "unit of account," but this may not always be the case under the ASU. A&D entities may need to change their existing policies and processes to ensure that they are applying the ASU's guidance consistently throughout their organization.

Warranties

The ASU retains the current cost accrual model related to accounting for warranty obligations (in accordance with ASC 460), but only for warranties that ensure that a product complies with agreed-upon specifications. To the extent that a warranty constitutes any other service, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognized as it is satisfied). The warranty would also be accounted for as a performance obligation if the customer has the option of purchasing it separately.

Under the ASU, entities must determine the transaction price by estimating any variable consideration (including potentially contingent consideration).

Although warranties that a product is free of latent defects and in compliance with agreed-upon specifications are common in the A&D industry and the accounting for such warranties is not likely to change, an entity should carefully consider circumstances in which a warranty offers services in addition to those described above. The timing of revenue recognition may change if such a warranty meets the criteria for treatment as a performance obligation. In assessing whether aspects of a warranty represent a performance obligation, an entity may need to use significant judgment. For example, a warranty agreement may provide for certain services that are more akin to maintenance than a simple assurance that the product meets certain specifications. In such cases, those services may need to be treated as a performance obligation (an allocated portion of revenue would be deferred) rather than as a warranty obligation (under a cost accrual model).

Determine the Transaction Price (Step 3)

Under the ASU, entities must determine the transaction price[5] by estimating any variable consideration (including potentially contingent consideration). Estimates of variable consideration are only included in the transaction price to the extent that it is probable that the amount of cumulative revenue recognized would not be subject to a significant future revenue reversal when such estimates are revised.

[5] The transaction price is defined as "the amount of consideration . . . to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties" and consists of both fixed and variable consideration.

Thinking It Through

A&D entities often enter into contracts that include variable consideration such as incentive fees or penalties. Further, modifications and change orders could result in pricing uncertainty, potentially creating variable consideration. Such variable consideration would be estimated by taking into account available information (e.g., past history or projected sales) and would only be included in the transaction price to the extent that it is probable that its inclusion would not result in a significant future revenue reversal. Depending on how management applied the guidance in ASC 605-35 on estimating contract revenue, an A&D entity's accounting for variable consideration under the ASU may ultimately be consistent with its current accounting. However, because the new guidance prescribes a specific threshold (probable) that entities must meet to include variable consideration in estimated revenue, entities may need to evaluate their contracts under the ASU to assess whether their current accounting remains appropriate.

Example

An entity enters into a contract to develop a missile launch system for the government. The contract price is $100 million plus a $20 million (all-or-nothing) incentive fee if the system is placed online within three years of contract inception. On the basis of its experience with developing similar systems, the entity concludes that it is probable that the system will be placed online within three years. As a result, the incentive fee is included in the transaction price and revenue of $120 million (the fixed consideration of $100 million plus the variable consideration of $20 million) is recognized in accordance with the ASU's other requirements. The estimated transaction price would be updated in each reporting period. Any adjustments would be treated as a change in estimate and, in accordance with ASC 606-10-32-42 through 32-45, would be recognized as revenue, or as a reduction of revenue, in the period in which the transaction price changes (i.e., a cumulative catch-up adjustment would be recorded to revenue in the current period).

The ASU requires entities to adjust the transaction price for the time value of money when a significant financing component exists (and provides guidance on determining when such a financing exists).

Adjusting for the Time Value of Money

The ASU requires entities to adjust the transaction price for the time value of money when a significant financing component exists (and provides guidance on determining when such a financing exists). The objective of this requirement is to adjust the promised amount of consideration to reflect what the selling price would have been if the customer had paid cash for the goods or services at the time (or over the period during which) such goods or services were transferred to the customer. As a practical expedient, an entity is not required to account for a significant financing component in a contract if, at contract inception, the expected time between payment and the transfer of the promised goods and services is one year or less. In addition, a significant financing component would not exist if the difference between the promised consideration and the cash selling price of the good or service arises "for reasons other than the provision of finance . . . and the difference between those amounts is proportional to the reason for the difference."[6]

[6] ASC 606-10-55-244 through 55-246 provide an example of factors to consider in the assessment of whether the payment terms in a contract were structured primarily for reasons other than the provision of finance to the entity.

Thinking It Through

A&D entities commonly enter into contracts with varying payment terms. To the extent that an A&D entity receives an up-front payment for which the related revenue will be recognized over several years or the customer is not required to pay for a certain period after a performance obligation is satisfied, the transaction price may need to be adjusted for the time value of money (as if a hypothetical loan was provided to one of the parties in the contract). However, in some situations, the payment terms may be structured for reasons other than financing, such as to provide customers with protection from the entity's failure to adequately complete some or all of its obligations under a contract. The ASU would not require an entity to account for a significant financing component if the payment terms were structured for reasons other than for "the provision of finance."

Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation (Step 5)

Under the ASU, an entity recognizes revenue as "control"[7] of the goods or services underlying a performance obligation is transferred to the customer. This control-based model differs from the risks-and-rewards model generally applied under current U.S. GAAP. Entities must first determine whether control is transferred over time. If not, it is transferred at a point in time. Under the ASU, control is transferred over time if any of the following criteria are met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . 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."

If none of these criteria are met, an entity would determine the point in time at which the customer obtains control of the good or service. Factors indicating that control has been transferred at a point in time include, but are not limited to, the following:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

Under the ASU, an entity recognizes revenue as "control" of the goods or services underlying a performance obligation is transferred to the customer. This control-based model differs from the risks-and-rewards model generally applied under current U.S. GAAP.

Thinking It Through

Under current U.S. GAAP, A&D entities often recognize revenue from customer arrangements by using a percentage-of-completion method under ASC 605-35. In these arrangements, the ASU's model for determining whether revenue is recognized over time or at a point in time may not significantly affect how revenue is recognized (i.e., many arrangements will qualify for recognition of revenue over time). However, A&D entities cannot presume that arrangements currently within the scope of ASC 605-35 that are accounted for under the percentage-of-completion method will meet the ASU's requirements for recognition of revenue over time (i.e., in certain arrangements, revenue may need to be recognized at a point in time).

[7] "Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset" as well as "the ability to prevent other entities from directing the use of, and obtaining the benefits from, [the] asset."

Measuring Progress Toward Satisfaction of a Performance Obligation

If a performance obligation is satisfied over time, an entity recognizes revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of the goods or services to the customer. The ASU provides specific guidance on measuring progress toward completion, including the use and application of output and input methods. For example, the ASU requires an entity that applies an input method of measuring progress toward completion to exclude "the effects of any inputs that . . . do not depict the entity's performance in transferring control of goods or services to the customer" (for example, the "costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract)."

The ASU notes that, in certain circumstances, an entity may not be able to reasonably measure the progress toward complete satisfaction of a performance obligation. In such circumstances, the entity would be required to recognize revenue to the extent of costs incurred (i.e., at a zero profit margin) if the entity expects to recover such costs.

Further, the ASU indicates that to the extent that costs incurred are not proportional to an entity's progress in satisfying its performance obligation(s), the entity might best depict its performance by adjusting the input method to recognize revenue only to the extent of the costs incurred.

The ASU does not permit entities to use the completed-contract method. Therefore, A&D entities that have historically used this method to recognize revenue will need to adjust their revenue recognition policies to comply with the ASU's requirements.

Thinking It Through

Under ASC 605-35, if an entity is unable to reasonably estimate its progress toward completion of performance under a contract, the entity often uses the completed-contract method to recognize revenue. However, the ASU does not permit entities to use the completed-contract method. Therefore, A&D entities that have historically used this method to recognize revenue will need to adjust their revenue recognition policies to comply with the ASU's requirements.

Example

On July 1, 20X1, an aerospace company entered into a contract to provide a product to a customer for $20 million. The company has determined that the contract represents a single performance obligation and that it should recognize revenue over time by using a cost-based input method. The total cost of the product is $18 million, including $12 million to purchase uninstalled materials and $6 million for the remaining activities associated with manufacturing the product. The materials are purchased at inception of the contract, and the company has determined that the materials meet the conditions in ASC 606-10-55-21(b) and should therefore be accounted for as uninstalled materials. As of December 31, 20X1, the company has incurred costs of $2 million toward completing the manufacturing. The remaining costs are incurred during the subsequent year.

In this example, the company would record revenue equal to cost when the uninstalled materials are purchased and would record the remaining revenue of $8 million ($20 million less $12 million) ratably as the costs related to manufacturing are incurred.

Consequently, the entity recognizes the following:

July 1, 20X1 — Purchase of the uninstalled materials for $12 million:	
Revenue upon purchase of the uninstalled materials	$ 12,000,000
Cost of revenue	12,000,000
Profit margin	$ 0
For the six months ended December 31, 20X1:	
Revenue (one-third of $8 million of remaining revenue)	$ 2,666,667
Cost of revenue (one-third complete toward total of $6 million of costs for manufacturing)	2,000,000
Profit margin	$ 666,667

Example (continued)		
For the subsequent year:		
Revenue (two-thirds of $8 million of remaining revenue)	$	5,333,333
Cost of revenue (remaining two-thirds of total of $6 million of costs for manufacturing)		4,000,000
Profit margin	$	1,333,333

Contract Costs

The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract. Specifically, entities are required to capitalize recoverable incremental costs of obtaining a contract (e.g., sales commissions).

In addition, if the following criteria are met, an entity would capitalize the costs of fulfilling a contact that are not within the scope of other Codification topics:

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

Nevertheless, under the ASU, costs related to satisfied (or partially satisfied) performance obligations must be expensed as incurred. As a result, for performance obligations satisfied over time, costs related to the partially satisfied performance obligations would need to be expensed as incurred.

Costs capitalized under the ASU would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (i.e., as the related revenue is recognized). In certain circumstances, the amortization period may extend beyond the original contract term (e.g., when future anticipated contracts or expected renewal periods exist). All capitalized-cost assets would be subject to impairment testing if any impairment indicators exist.

The ASU's requirement to expense costs related to partially satisfied performance obligations could represent a significant change from current practice for A&D entities that currently recognize revenue under a method other than "cost to cost."

Thinking It Through

Depending on how A&D entities are currently accounting for revenue-related costs, the ASU may cause a change in practice. Entities will most likely have to reevaluate whether the capitalization of certain costs for construction and other long-term contracts (such as precontract bid and proposal costs) remains appropriate under the ASU.

Further, the ASU's requirement to expense costs related to partially satisfied performance obligations could represent a significant change from current practice for A&D entities that currently recognize revenue under a method other than "cost to cost." That is, the inability to capitalize such costs and recognize them when the related revenue is recognized may result in more fluctuations in margins than under current U.S. GAAP.

Example

An entity enters into a contract with a customer to construct a prototype fighter jet for $500 million over a two-year period. The entity incurs design costs of $20 million related to the proposal process and contract commission costs of $10 million as a result of obtaining the contract.

Since the design costs would have been incurred regardless of whether the entity was awarded the project, the costs do not represent costs to obtain a contract. However, the entity would need to determine whether the costs must be capitalized as costs to fulfill the contract (i.e., whether the costs related directly to the contract generate or enhance a resource that will be used to satisfy a future performance obligation and are expected to be recovered). If so, and since the costs are not related to a satisfied or partially satisfied performance obligation (they represent precontract costs for which the related revenue has not yet been recognized), the entity would capitalize and amortize such costs in accordance with the ASU.

Because the contract commission costs would not have been incurred if the entity was not awarded the project, the costs represent costs to obtain a contract. The entity would apply the ASU when capitalizing and amortizing such costs (the practical expedient allowing for immediate expense of the costs would not apply since the amortization period is expected to be the two-year construction period).

Provision for Loss Contracts

The ASU amended the current requirements in ASC 605-35 but retained the requirement to evaluate whether a provision for a loss contract is required. For arrangements within the scope of ASC 605-35, an entity would need to assess as of each reporting period whether it expects to incur a loss on the basis of its current estimates of (1) the amount of consideration that the entity expects to be entitled to in exchange for transferring promised goods or services to the customer and (2) contract cost. If the entity estimates that a loss will be incurred, a provision for the loss on the contract is required. This assessment should be performed at the performance obligation level.

The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards.

Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards. For additional information about the new disclosure requirements, see Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

The ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016, for public entities. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to

contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities should begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and determine the transition approach that is practical to apply and most beneficial to financial statement users.

Challenges for A&D Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the ASU's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for A&D entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

To comply with the ASU's new accounting and disclosure requirements, A&D entities will have to gather and track information that they may not have previously monitored.

Retrospective Application

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, A&D entities may need to review contracts that commenced several years before the ASU's effective date. In addition, A&D entities will most likely be required to perform dual tracking of revenue balances during this retrospective period, given the potential difficulty associated with retroactively recalculating revenue balances when the ASU becomes effective.

Systems, Processes, and Controls

To comply with the ASU's new accounting and disclosure requirements, 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. Further, to ensure the effectiveness of internal controls over financial reporting, management may want to assess whether it should implement additional controls. A&D entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU's guidance.

Note that the above are only a few examples of changes A&D entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available. 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 relevant tax authorities to use the new method. Similar requirements may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), A&D entities should start carefully examining the ASU and 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 ASU

The table below summarizes key differences between current U.S. GAAP and the FASB's ASU regarding long-term contracts in the A&D industry. It does not address all possible fact patterns and should be read in conjunction with the ASU.

	Current U.S. GAAP	ASU	Impact
Scope	This guidance generally applies to contracts for which the customer provides specifications regarding "the construction of facilities or the production of goods or the provision of related services." Such products do not include goods manufactured in a standard manufacturing operation. The guidance may also apply to other arrangements, such as federal government contracts (subject to ASC 912) or certain software arrangements (as specified in ASC 605-985[1]). (SOP 81-1, ¶ 11)	This guidance applies to contracts with customers. Arrangements subject to other guidance, such as leases, insurance contracts, certain financial instruments, guarantees, and certain nonmonetary exchanges, are outside the ASU's scope. (ASC 606-10-15-1 through 15-5) An entity is precluded from recognizing revenue unless the arrangement meets the ASU's definition of a "contract." For example, a contract does not exist if it is not probable that the entity will collect the consideration to which it expects to be entitled. When the ASU's definition of a contract is not met and the entity receives consideration from the customer, the entity will only recognize the consideration received as revenue when either (1) the entity has no remaining obligations to transfer goods or services to the customer and substantially all of the consideration has been received by the entity and is nonrefundable or (2) the contract has been terminated and the consideration received is nonrefundable. (ASC 606-10-25-1 through 25-8)	Contracts previously accounted for under SOP 81-1 are within the ASU's scope. Further, entities will need use the ASU's criteria to ensure that a contract exists before recognizing any revenue under the contract. (This may be different from the entity's current practice under U.S. GAAP.)
Determining the profit center/unit of account	The basic presumption is that the contract is the profit center (unit of account) for income measurement. (SOP 81-1, ¶ 17 and 34; AICPA Audit & Accounting Guide *Construction Contractors* (AAG), ¶ 2.09)	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." (ASC 606-10-25-9) An entity analyzes the identified contract to assess the goods or services and identify the entity's performance obligations.[2] (ASC 606-10-25-14)	Entities can no longer assume that the entire contract is an acceptable unit of account. An entity must analyze contracts to determine whether combination or segmentation is required. This analysis may result in more units of account than under current U.S. GAAP (despite more frequent contract combination).
Combination of contracts with a single customer	Multiple contracts with a single customer may be combined for accounting purposes depending on certain criteria, including how the contracts were negotiated and the extent to which the activities are interrelated. (SOP 81-1, ¶ 37)	The ASU provides specific criteria that must be met for an entity to conclude that a contract with a customer exists. (ASC 606-10-25-1) Two or more contracts **must** be combined to form a single contract if the contracts are entered into around the same time and with the same customer (or related parties) and if any 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 price or performance of the other contract." • All (or some) of the goods or services promised in the contracts are a single performance obligation (i.e., they are not "distinct," as that term is defined in the ASU). (ASC 606-10-25-9)	Contract combination may be more frequent and will not be optional. Note that contracts with multiple customers (that are not related parties) will not meet the criteria for contract combination.
Combination of production contracts	Production contracts using the units-of-delivery basis of the percentage-of completion 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)		

[1] Formerly AICPA Statement of Position 97-2, *Software Revenue Recognition*.

[2] A performance obligation is a promise in a contract with a customer (whether explicit or implicit) to transfer to the customer either a distinct good or service (or bundle) or "a series of distinct goods or services that are substantially the same and have the same pattern of transfer" to the customer.

	Current U.S. GAAP	ASU	Impact
Segmentation	Segmentation is not required. In general, a contract may be segmented if either of the following criteria is met: • 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)	At contract inception, an entity must analyze the goods or services promised in the contract to identify each performance obligation. A performance obligation is a promise in a contract with a customer (whether explicit or implicit) to transfer to the customer either a distinct good or service (or bundle) or a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. (ASC 606-10-25-14) A good or service is distinct if the following criteria are met: • "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 (that is, the good or service is capable of being distinct)." • "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." (ASC 606-10-25-19) The ASU provides specific indicators for evaluating whether a promised good or service is separable from other promises in the contract (the second criterion above). For example, the good or service would be separable if it "does not significantly modify or customize other goods or services in the contract" or the "entity does not provide a significant service of integrating" goods or services in the contract. (ASC 606-10-25-21)	The ASU's requirements will most likely result in an increase in the number of units of account. In a production contract, units that meet the criteria for being distinct must be accounted for separately to the extent that they are delivered in different accounting periods (unless they represent a series of distinct goods or services that are the same and have the same pattern of transfer (as defined in ASC 606-10-25-15)). Contracts that combine development and production may include separate units of account if the goods or services are distinct.
Production contracts	For a production contract under which the units-of-delivery method is employed, segments may be assigned to production lots or releases so that estimated average unit cost may be used. 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 account under the ASU.
Warranty	A warranty may be segmented (i.e., revenues are allocated to and separately recognized as warranty revenue) if it meets the criteria for segmentation. (SOP 81-1, ¶ 40–41)	The ASU retains the current cost accrual model related to the accounting for warranty obligations. However, 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 (or part of the warranty) "provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications." (ASC 606-10-55-30 through 55-35)	Entities may need to analyze their warranties to determine whether they constitute a service beyond assuring the agreed-upon specifications of the good or service provided to the customer. To the extent that the warranty provides any other service, the service would be accounted for as a performance obligation (revenue would be deferred) rather than as a warranty obligation (a cost accrual model would be used).
Customer options for additional goods or services	Entities may not currently treat customer options for additional goods or services as separate deliverables before the options are executed.	An option in a contract gives rise to a performance obligation if it provides the customer with a "material right" that it would not have received without entering into the contract. An estimate of the stand-alone selling price for the option should include adjustments for (1) "[a]ny discount that the customer could receive without exercising the option" and (2) the "likelihood that the option will be exercised." (ASC 606-10-55-41 through 55-45)	In certain circumstances, options for additional goods or services provided to the customer would need to be treated as a performance obligation (separate unit of account). Unless an entity currently treats such options as a separate element in its arrangements with customers, a deferral of revenue may result (unlike under current practice).
Contract modifications (change orders, executed options, and additions)	An addition to an existing contract (e.g., a change order) 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)	A contract modification is treated as a separate contract if it results in both of the following: • The addition of a distinct performance obligation (or obligations). • A change in consideration that reflects the stand-alone selling price of that performance obligation.[3] Regarding a contract modification that is not a separate contract, the ASU provides guidance on determining whether to account for the modification either (1) as a termination of the original contract and the creation of a new contract (i.e., the amount of consideration not yet recognized is allocated to the remaining performance obligations) or (2) as if it were part of the original contract (i.e., by updating the transaction price, measuring progress toward complete satisfaction of the performance obligation, and recording a cumulative catch-up adjustment to revenue). (ASC 606-10-25-10 through 25-13)	An entity will need to evaluate contract modifications to determine whether (1) they should be treated as separate contracts under the ASU's definition of a contract (which may differ from how entities currently evaluate such modifications) or (2) the entity needs to recalculate the transaction price and update the measure of progress to date toward satisfying the performance obligation(s) in the modified contract (which generally should be consistent with current practice).

[3] The price may be adjusted to reflect the particular circumstances of the contract. Such circumstances may include a discount that the customer receives because it is not necessary for the entity to incur selling-related costs that it would incur when selling a similar good or service to a new customer, but would not reflect volume or other discounts related to the original contract.

	Current U.S. GAAP	ASU	Impact
Revenue elements	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 (e.g., award fees would only be included to the extent a reasonably dependable estimate can be made). Revenue is allocated among segments on the basis of the relative value of each segment. (SOP 81-1, ¶ 39, 62, and 65–66; AAG, ¶ 2.12) Estimated incentives, award fees, and other performance incentives are included in estimate-at-complete (EAC)[4] revenue and therefore affect current results. Award fees and other performance incentives are included in EAC revenue to the extent that a reasonably dependable estimate can be made. (AAG, ¶ 2.12)	Total revenue is based on the contract terms and the entity's customary business practices (e.g., a history of providing price concessions for similar contracts). The transaction price to be allocated to the various performance obligations in the contract is the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to a customer. It may include fixed amounts, variable amounts, or both. It may also include cash consideration, noncash consideration, consideration payable to a customer, all three, or a combination thereof. It is not adjusted for the effects of the customer's credit risk. Estimated revenues are included in the transaction price only to the extent that the entity concludes it is probable that a subsequent change in the estimate would not result in a significant revenue reversal (e.g., an entity would most likely not include an estimate of the consideration to be received for unpriced modifications or modifications whose scope is not approved unless it is able to determine that it would have a legally enforceable right to receive the additional consideration). 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). See Allocation of revenue below for further discussion about allocating the transaction price. (ASC 606-10-32-2 and 32-3, ASC 606-10-32-11, and ASC 606-10-32-31 through 32-33)	The estimates of the total transaction price may be different to the extent that award fees or performance incentives were included or excluded under current U.S. GAAP (because of the inability to develop a reasonably dependable estimate). The 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 ASU. Revenue recognition may be accelerated or delayed if there are any differences in the total transaction price. See discussion of differences between allocation methods under Allocation of revenue below.
Unpriced change orders	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: • If cost recovery is probable, "revenue should be recognized to the extent of the costs incurred."[5] • Revenue may be recognized in excess of costs incurred if the amount can be reasonably estimated and assured beyond a reasonable doubt. If cost recovery is not probable, revenue is not adjusted. (SOP 81-1, ¶ 62)	An entity must use significant judgment to determine whether a contract modification exists when the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price. Specifically, an entity is required to assess whether it can identify the payment terms associated with the modification. An entity would include an estimate for unpriced change orders in the transaction price if it determines, on the basis of the underlying contractual terms, that it has enforceable rights to payment for its performance. The entity would include its estimate in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved. (ASC 606-10-25-11 and ASC 606-10-32-11)	Revenue recognition related to unpriced change orders may be delayed to the extent that an entity does not possess sufficient evidence that the change order will be approved or the price is variable (and therefore is unable to assert that the estimate of such revenue is not subject to a significant revenue reversal). The ASU does not provide specific guidance on determining when this criterion has been met; however, an entity should consider the factors in ASC 606-10-32-12 when making this determination.
Claims[6]	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.[7] (SOP 81-1, ¶ 65–66)	An entity must use significant judgment to determine whether a contract modification exists when the parties to a contract have a dispute about the scope or price (or both) of the modification. Specifically, an entity is required to determine whether a contract exists and, if so, estimate the variable consideration that it will be entitled to by using either the most-likely-value approach or the expected-value approach and subject its estimate to the constraint. (ASC 606-10-25-11, ASC 606-10-32-11, and ASC 606-10-55-134 and 55-135)	Revenue recognition related to claims may be accelerated if an entity is able to determine that it has a legally enforceable right to consideration related to a claim in excess of its costs.

[4] This represents the total estimated amount for the unit of account.

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

[6] 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.

[7] A seller may adopt an accounting policy of adjusting claim revenues only when the revenues are received.

	Current U.S. GAAP	ASU	Impact
Time value of money	Generally, the time value of money is not considered.	The time value of money should be reflected in the promised consideration when the contract includes a significant financing component. The interest rate used should reflect a hypothetical financing-only transaction between the entity and the customer on the date of contract inception. This calculation is not required if, at contract inception, the expected time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services will be one year or less. (ASC 606-10-32-15 through 32-20)	Companies will need to assess whether a contract includes a significant financing component and may need to adjust total revenue and recognize interest income or expense.
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)	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).[8] In certain circumstances, exceptions may apply to the following: • Discounts. • Variable consideration. • Changes in the transaction price. (ASC 606-10-32-28 and 32-29 and ASC 606-10-32-32 and 32-33)	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. In certain circumstances, the method for allocating the transaction price may yield results that are not considered representative of the underlying economics, including: • Contracts containing performance obligations of mixed fee types. • Discounts and contingent consideration that are related to specific performance obligations but that do not meet the criteria for allocation to those obligations.
Timing of revenue/cost recognition	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: ***Alternative A***[9] • Incurred-to-date (ITD) revenue = EAC revenue × % complete. • Cost of earned revenue = EAC cost × % complete. ***Alternative B*** • ITD margin = EAC margin × % complete. • Cost of earned revenue = Actual costs incurred.[10] Other calculations are required when reasonably dependable estimates cannot be made and when a loss is expected. (SOP 81-1, ¶ 25 and 79–81; AAG, ¶ 2.04–.06 and 2.27)	Revenue and costs are recognized upon satisfaction of performance obligations (i.e., when the customer obtains control of the promised goods or services).[11] When control is transferred at a point in time, 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. Revenue recognition on an incomplete good or service (like percentage-of-completion accounting) is only appropriate when control is transferred over time, as defined in the ASU (see Requirements for percentage-of-completion accounting below). Other calculations are required when a reasonable measure of progress cannot be made and may be required when a loss is expected on the entire contract. (ASC 606-10-25-23 through 25-37)	An entity must analyze performance obligations to determine when control is transferred (and therefore when revenue can be recognized). Certain contracts may no longer qualify for revenue recognition during the construction period. For production contracts for which the units-of-delivery method is currently used and for which the entity has determined that such method is appropriate under the ASU, the timing of revenue recognition may not differ significantly. However, costs may need to be expensed as incurred. For other contracts, the timing of revenue recognition may be significantly later to the extent that the transfer of control is not over time.[12] It may no longer be acceptable for entities to recognize revenue under the Alternative B method for certain contracts (allowed under SOP 81-1). Costs of earned revenue will be based on the cost of the transferred goods or services.

[8] 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.

[9] 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.

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

[11] Control refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Benefits are the potential direct or indirect cash flows (i.e., inflows or savings in outflows) 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).

[12] 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	ASU	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 three criteria is met: • The customer simultaneously receives and consumes the benefits as the entity performs. • "The entity's performance creates or enhances an asset . . . 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 [e.g., inability to transfer to another customer without substantial rework] and the entity has an enforceable right to payment for performance completed to date"[13] and expects to fulfill the contract as promised. (ASC 606-10-25-27)	Certain contracts/performance obligations may no longer 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 control of goods or services. Input or output measures may be used.[14] The ASU states that output methods may often result in the most faithful depiction of an entity's performance. If an entity is not able to reasonably measure the outcome of a performance obligation (e.g., in the early stages of a contract) but expects to recover its costs, the entity should recognize revenue to the extent of costs incurred until it can reasonably measure the outcome of the performance obligation. (ASC 606-10-25-31 through 25-37 and BC164)	Entities may need to reevaluate the manner in which they measure progress toward completion.
Adjustments to input and output measures	When using a cost-incurred input measure, an entity should disregard certain costs that are unrelated to performance (e.g., significant uninstalled materials). (SOP 81-1, ¶ 50)	Percentage-of-completion calculations exclude the following: • "[G]oods or services for which the entity does not transfer control to a customer." • For input measures, (1) wasted materials, labor, or other resources not reflected in the price of the contract (i.e., the unexpected amounts) and (2) significant material procurement in advance of the related efforts (in certain instances, these costs may need to be recognized at a zero margin). (ASC 606-10-25-34 and ASC 606-10-55-21) In the early stages of a contract, "an entity may not be able to reasonably measure the outcome of a performance obligation" but may expect "to recover the costs incurred in satisfying the performance obligation." In such cases, "the entity shall recognize revenue only to the extent of the costs incurred" (recognize revenue at a zero margin). (ASC 606-10-25-37)	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. In some instances, significant material procurement, in advance of related efforts, will be recorded as the cost of sales at a zero margin (as opposed to being capitalized or excluded from the percentage-of-completion calculation).
Provision for anticipated losses	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)	An entity would need to assess in each reporting period whether it expects to incur a loss on the basis of its current estimates of (1) the amount of consideration that it expects to be entitled to in exchange for transferring promised goods or services to the customer and (2) contract cost. If an entity estimates that a loss will be incurred, a provision for the loss on the contract is required. This assessment should be performed at the performance-obligation level. (ASC 605-35-25-45 through 25-49)	Entities will be required to perform their loss contract assessment at a more granular level.

[13] 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.

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

	Current U.S. GAAP	ASU	Impact
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. (SOP 81-1, ¶ 79–81)	If the consideration an entity expects to be entitled to under a contract includes a variable amount, the entity should estimate the amount it expects to be entitled to by using whichever of the following methods better predicts that amount: • *"Expected value" approach* — Typically used if the entity has a contract with a large number of outcomes within a narrow range. • *"Most likely amount" approach* — Typically used if a contract has only two possible outcomes (e.g., an entity receives a performance bonus or does not). However, the entity's estimate of variable consideration should be included in the transaction price only to the extent that the entity concludes that it is probable that a subsequent change in the estimate of the amount of variable consideration would not result in a significant revenue reversal. The entity must reperform this assessment as of each reporting date. Factors that indicate that including an estimate of variable consideration in the transaction price could result in a significant revenue reversal include: • "The amount of consideration is highly susceptible to factors outside the entity's influence" (e.g., judgment of third parties, weather conditions). • "The uncertainty . . . is not expected to be resolved for a long period of time." • The extent of "experience (or other evidence) . . . is limited." • The entity has a practice of offering a broad range of price concessions or changing the payment terms and conditions of similar contracts. • Existence of a large number and broad range of possible outcomes. (ASC 606-10-32-8 and ASC 606-10-32-11 and 32-12)	An entity will continue to be required to use significant judgment to estimate the amount of variable consideration in a contract that is not subject to significant revenue reversal as of each reporting date. A significant portion of revenue recognized under contracts for which consideration is based on the price of a commodity or currency on a future date may be delayed until the uncertainty regarding the amount of variable consideration is resolved.
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, ¶ 2.18–2.20)	Costs to fulfill a contract are capitalized (included in contract costs) if they meet the requirements in other standards (e.g., inventory). Other costs to fulfill a contract must be capitalized if they (1) are directly related to a current or specific anticipated contract, (2) generate or enhance resources of the entity that will be used in satisfying (or continuing to satisfy) performance obligations in the future, and (3) are expected to be recovered. The following costs must be expensed as incurred: • General and administrative (G&A) costs that are not explicitly chargeable to the customer. • "Costs of wasted materials, labor, or other resources . . . that were not reflected in the price of the contract." • "Costs that relate to satisfied performance obligations (or partially satisfied performance obligations)." • Costs related to remaining performance obligations but that the entity cannot distinguish from costs related to satisfied performance obligations. (ASC 340-40-25-5 through 25-8)	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, whether units are considered distinct (i.e., the number of identified performance obligations), and whether the contract terms specifically allow an entity to charge costs to its customer.
Precontract costs	Precontract start-up costs are typically expensed as incurred. Other precontract costs may be capitalized[16] in the following instances: • 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." • 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)		

[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	ASU	Impact
Costs of obtaining a contact	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 if the entity expects to recover the costs. Otherwise, such costs are expensed as incurred unless they are explicitly chargeable to the customer, regardless of whether the contract is obtained. Capitalized costs are then "amortized on a systematic basis that is consistent with the transfer to the customer 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 one year or less. (ASC 340-40-25-1 through 25-4)	Certain costs of obtaining a contract may need to be capitalized and amortized.
G&A expenses	Generally, G&A costs are expensed as incurred and are not included in contract costs, except: • To the extent they are considered allowable costs[17] for government contracts. • To the extent they are 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)	In general, G&A costs are expensed as incurred unless they are explicitly chargeable to the customer. (ASC 340-40-25-8)	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).

[17] See footnote 10.

Subscriptions

Don't miss an issue! Register to receive Spotlight and other Deloitte publications by going to www.deloitte.com/us/subscriptions, choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance, risk, and compliance.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Join *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available for this upcoming *Dbriefs* webcast. Use the link below to register:

- EITF Roundup: Highlights From the September Meeting (September 23, 2 p.m. (EDT)).

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our new free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, the AICPA, the SEC, the IASB, and the IFRS Interpretations Committee. Check it out today!

The Spotlight series is prepared by the National Office Accounting Standards and Communications Group of Deloitte. New issues in the series are released as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.