AVIATION WORKING GROUP

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Aviation Working Group – Comments on Revenue Recognition Project

Dear Sir David Tweedie and Ms. Seidman:

Aviation Working Group (***AWG***) is an industry group whose members consist of the leading manufacturers, lessors, and financiers of aircraft and aircraft engines. The members of AWG are both preparers and users of financial statements. AWG has been closely following and reviewing with interest the revenue recognition project activities of the FASB and IASB (the ***Boards***).

AWG is providing this letter to respond to the questions asked by the Boards following the issuance of the Exposure Draft (the ***ED***), including the Implementation Guidance (***IG***) and Basis for Conclusion (***BC***).

We support convergence of International Financial Reporting Standards (***IFRS)*** and generally accepted accounting principles in the United States (***US GAAP***) towards single harmonized accounting standards. We also support the Boards' efforts to create a revenue recognition standard that improves consistency across various industries and geographies and reduces the number of standards to which entities have to refer. If a single revenue recognition rule for products, services and construction contracts is not feasible, we believe the Boards should provide separate guidance for long-term contracts. Certain principles set forth in the ED will not accurately reflect the underlying economics of our business or provide decision-useful information to investors. Key areas of concern are summarized below:

- **Contract costs -** We believe that the Boards did not intend to change the parts of IRFS and US GAAP that allow for deferral of certain costs relating to work-in-process on some types of long-term contracts. Yet the proposed guidance would significantly alter accounting for such

contract costs. Numerous contractors today use average costing and lot accounting, which often results in capitalized deferred production costs. The proposed guidance will require contractors to measure costs for each performance obligation and expense all costs related to completed performance obligations. The financial results under the new proposed revenue and cost accounting model will not be representative of underlying contract or program economics. We urge the Boards to retain existing GAAP for costs associated with long-term contracts and programs.

- **Onerous obligations -** Recognizing onerous obligations at the performance obligation level could lead to contractors recognizing losses at contract signing for onerous performance obligations despite an overall contract being profitable. Onerous obligations should be assessed at the contract or program level.

- **Contract segmentation -** We understand that the Boards provided segmentation guidance to avoid users having to reallocate a variable transaction price across multiple performance obligations and to properly address the scope of the guidance. There needs to be a mechanism to allocate a variable transaction price or change in variable transaction price to a specific performance obligation, however we do not believe that the segmentation guidance would achieve the intended purpose. The Boards should eliminate the guidance on segmentation and add further guidance that allows changes in estimated transaction prices to be allocated to specific performance obligations and to allow performance obligations to be excluded from the scope of the standard if covered elsewhere.

- **Identification of performance obligations -** The identification of performance obligations should not be based solely on whether a good or service, or bundle of goods or services, is distinct. We recommend that a contract for multiple units of highly specialized equipment built to a customer's specification should be accounted for as a single profit center, while a contract for multiple units of a standard product that are sold to many customers represents multiple performance obligations. We consider that the intentions of the contracting parties as well as underlying negotiations and pricing must be considered in determining the number of performance obligations in a contract. The Boards should improve the proposed guidance to require consideration of the intent of the contracting parties and the underlying economics of the transactions when identifying performance obligations. Also, we are concerned that the introduction of the concept of distinct profit margin may result in negating the intent of the Board in accounting for contract modifications.

- **Continuous transfer of control** – In our industry, proportional or percentage of completion revenue recognition is critical. The proposed criteria for transfer of control may preclude proportional revenue recognition on certain arrangements based on contractual terms and conditions. The current language in the ED does not provide sufficient guidance with respect to when continuous transfer of control exists. We urge the Board to provide indicators of contractual relationships that are evident in a continuous transfer of control model. We believe that the proposed guidance does not adequately address the numerous contractual circumstances that further support the continuous transfer model.

- **Variable consideration** – An entity should recognize revenue based on an estimated transaction price in the appropriate circumstances. Paragraphs 38 and 39[1] are too prescriptive. They may be viewed by some to preclude recognition of variable consideration when a company is offering new products or services. Yet our members frequently develop new products for our customers, and because contracts typically include bonus and penalty clauses, estimate the final transaction price. We support this best estimate approach because we believe using a probability weighted method will be unnecessarily complex and will result in financial statements reflecting results that can never materialize.

- **Disclosure -** The demands of preparing the additional quantitative disclosures and tabular reconciliations of balance sheet amounts which are described in the proposed guidance will significantly outweigh the benefits provided to our investors. Furthermore, the proposed requirement to disclose the total amount of long-term performance obligations and the expected timing of their satisfaction will not provide meaningful information to the financial statement user nor add to the users' understanding of the amount, timing, and uncertainty of revenues and cash flows. In our industry we have very long cycles that result in a significant amount of backlog, with numerous outside factors affecting the satisfaction of our backlog obligations. We therefore propose elimination of the requirement to disclose timing of satisfaction of long-term performance obligations.

- **Transition -** We do not object to giving entities the option to apply the proposed guidance retrospectively. However, we urge the Boards to implement a transition alternative that would permit prospective application. Retrospective application of the proposed guidance will be costly, burdensome and impracticable for our members. Our members' contract base is composed of hundreds of thousands of contracts that often span a period of several years. Recasting contracts to their inception will be extremely complex and time-consuming and require the revision of quarterly estimates of profitability on a contract-by-contract basis over periods of many years. We recommend that the Boards permit prospective application for new arrangements entered into and arrangements materially modified after the date of adoption.

Recognition of revenue (paragraphs 8-33)

Question 1

Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:
(a) combine two or more contracts and account for them as a single contract;
(b) segment a single contract and account for it as two or more contracts; and
(c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

[1] Paragraph references are to the ED, unless otherwise stated.

Answer

1. Segmenting conditions

We agree with the proposed "pricing" principle, as it is conceptually consistent with existing literature. However, we do not agree with its application to segmenting. For the purposes of evaluating whether an entity shall combine two or more contracts, the Boards provided several qualitative indicators of pricing interdependence in paragraph 13. These indicators allow preparers to exercise judgment in concluding whether the contracts in substance represent a single arrangement between the entity and customer and, therefore, have interdependent pricing. This application of the pricing principle we believe is reasonable and consistent with the Boards' intent, as described in BC36, to provide suggestive indicators of price interdependence. However, for the purposes of evaluating whether an entity shall segment a single contract, the Boards have provided two conditions that are effectively a prescriptive, quantitative test, as illustrated in paragraph IG2 (FASB) / B2 (IASB). As written, we are concerned it could result in a proliferation of segmenting that would be inconsistent with the spirit of the related guidance on identifying performance obligations.

Integrate segmenting of contracts and separation of performance obligations

The Boards addressed the concern over the appearance of redundancy in segmenting contracts and identifying separate performance obligations in paragraph BC38. The Boards concluded that the segmentation principle was needed to simplify the assessment of scope and to allocate proportions of the transaction price. We agree that these issues are important, but we believe both can be addressed in the accounting for performance obligations. The following bullets highlight our proposed changes.

- Combination and segmentation of contracts (paragraphs 12-16). Paragraphs 15 and 16 would be deleted in lieu of the criteria for identifying separate performance obligations and the transaction price allocation guidance of paragraphs 50 through 53, which use the same standalone selling price principle as paragraph 16.

- Identifying separate performance obligations (paragraphs 20-24). Criterion 23 (a) would be deleted so that distinctness remains a principle as defined in criterion 23 (b). A new paragraph would then be added between 23 and 24 that would provide indicators of distinctness. On one end of the spectrum, the former language of 23 (a) could be used to demonstrate distinct performance obligations as the goods or services are commonly sold separately. On the other end of the spectrum, the language from BC54-59 could be used to demonstrate how the goods or services are so highly interrelated under a particular contract that they do not have distinct risks (such as significant contract management services) and, therefore, are not distinct performance obligations.

- Allocating the transaction price to separate performance obligations (paragraphs 50-52). The independent pricing principle from paragraph 15 would be incorporated into paragraph 51 as the first method of establishing standalone selling price, which is the same guidance as the first sentence in paragraph 16. The current allocation methodology

would still be used to address any contracts that meet the significant discount condition of paragraph 15 (b).

- Allocating subsequent changes in the transaction price (paragraph 53). The last sentence of paragraph 16 would be incorporated into paragraph 53 to provide the core principle – an entity shall allocate subsequent changes in the *transaction price* to the identified *performance obligations* to which those changes relate (that is, independent pricing). If the changes cannot be discretely identified with a performance obligation or subset of performance obligations, then the existing allocation guidance in 53 would be followed.

- A general statement would be added to the effect that when separate performance obligations fall within the scope of other standards, they should be accounted for in accordance with those standards. The Boards have stated that a contract should be segmented to 'simplify' the assessment of scope. If the portion of the contract that would otherwise be segmented is instead identified as a separate performance obligation, such performance obligations could then be excluded from the scope of the standard if covered elsewhere.

We believe this integrated approach would streamline the evaluation process by eliminating the current segmenting step, while maintaining the application of the pricing principle, and allow judgment by the preparer as to the economic substance of the contract. In addition, by moving the independent pricing principle to later in the model, it does not override the concepts of significant contract management services and customer-specific design or function, which are indicators of the economic substance of the contract.

We believe qualitative indicators of pricing independence should be used, consistent with the combined approach. These indicators would allow the preparer to use judgment in concluding whether the entity has agreed in substance to perform certain elements of the contract for the customer without regard to others and, therefore, the elements are priced independently. Indicators suggesting pricing independence may include instances where:

- some or all of the deliverables were bid for and negotiated separately, such that the customer could accept or reject them on an individual basis; and

- the performance of, and/or profit from, some or all of the deliverables does not impact or rely upon the others.

We believe this approach would create conceptually complementary indicators of pricing interdependence in paragraph 13 and pricing independence in 15, as well as resolve our concern that the current conditions in paragraph 15 could lead to non-substantive segmentation.

2. Evidence of interdependent pricing

Example 1 in paragraph IG2 is straightforward assuming simple products in an active marketplace that provides observable pricing. However, with complex products utilizing multi-tier subcontractors

or less active marketplaces, the application of the guidance is less clear. For example, would a prime contractor be required to segment a contract by virtue of the fact that their subcontractors regularly sell a particular good or service separately? We do not believe this is the intention of the Boards; indeed this is inconsistent with BC54-59. This confusion could be eliminated by clarifying that the comparison entities must regularly sell the goods or services to the same end customer.

Another example is an entity that provides complex products in response to a customer's request for proposal, which specifies the scope of goods and services to be provided. Those goods and services may be sold together or independently from customer to customer. In either case, the goods and services provided and the corresponding pricing are being driven by the customer's unique requirements, not by an active market for similar goods or services. A similar example is discussed in paragraph BC56 with respect to how significant contract management services impact the evaluation of performance obligations. We believe the concept of significant contract management services is an important indicator of price interdependence that is not apparent in the guidance. In other words, the customer is buying the contract management services, not the individual goods and services within the contract, and these services cannot be bifurcated in the performance of a complex, highly customized project. Therefore, we believe the Board should clarify that goods and services are not evaluated separately if they are provided in conjunction with significant contract management services (consistent with paragraph 23).

3. Contract modifications

Generally, we agree with how the pricing principle is applied to contract modifications; however, we would recommend including in paragraph 18 a statement that a contract modification must meet the conditions in both paragraphs 9 and 10. We believe this was the intention of the Boards, but this clarification would eliminate any question in practice.

Question 2

The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

Answer

Overall, we support the concept of identifying performance obligations to be accounted for separately and that the best evidence that a good or service is distinct is when the good or service is sold separately. We appreciate that the Boards have acknowledged in the application guidance in Paragraphs BC56 – BC59 that, in many instances, it does not make sense to separate long-term contracts into multiple performance obligations due to significant over-arching contract management services and pervasive risks involved in the production of highly complex deliverables. We believe that this concept should have more prominence in the proposed standard, supplementing the guidance provided in paragraphs 23 (a) and (b) for determining whether a good or service, or a bundle of goods or services, is distinct. Inclusion of this concept will ensure that contracts for highly complex deliverables with integrated contract management services and risks are accounted for consistently and the resulting accounting provides decision-useful information to investors.

Additionally, we believe that identification of performance obligations should not be based solely on whether a good or service, or bundle of goods or services, is distinct, including whether a performance obligation has a distinct profit margin. Rather, we believe that the intentions of the contracting parties as well as underlying negotiations and pricing should be contemplated in determining the number of performance obligations in a contract. For example, if a contractor typically submits separate proposals for each phase of a project, we believe that each phase represents a performance obligation. Likewise, if a contractor typically submits one proposal for all phases of a project, we believe that the contract represents the performance obligation. We recommend the Boards clarify the proposed guidance to require consideration of the intent of the contracting parties and the underlying economics of transactions in identifying performance obligations.

Furthermore, we believe that the treatment of inconsequential and perfunctory performance obligations should be carried forward from existing guidance. We do not agree that revenue recognition should be deferred for performance obligations that are considered inconsequential and perfunctory. We recommend that the Boards retain the existing approach by adding the following language to the performance obligation guidance included in the standard.

- *It is not necessary to apply the proposed recognition and measurement requirements to performance obligations that are inconsequential and perfunctory. A performance obligation would be inconsequential and perfunctory if it is not essential to other performance obligations in the contract and failure to complete it would not result in the customer receiving full or partial refund or rejecting the other performance obligations*

- *Indicators that a performance obligation is substantive rather than inconsequential or perfunctory:*
    - *The seller does not have a demonstrated history of completing the performance obligation in a timely manner and reliably estimating their costs.*
    - *The cost or time to complete the performance obligation for similar contracts historically has varied from one instance to another.*
    - *The skills or equipment required to complete the performance obligation are specialized and not readily available in the marketplace.*
    - *The cost of completing the performance obligation, or the fair value of the performance obligation, is more than insignificant in relation to such items as the contract fee, gross profit and operating income allocable to other performance obligations in the contract.*
    - *The period before the performance obligation will be extinguished is lengthy. Registrants should consider whether reasonably possible variations in the period to complete performance affect the certainty that the performance obligation will be completed successfully and on budget.*
    - *The timing of payment of a portion of the sales price is coincident with completing the performance obligation.*

We are concerned that the introduction of the concept of distinct profit margin may result in negating the intent of the Board in accounting for contract modifications. Under paragraph 10 of the current IAS 11 rules for construction contracts, which we are in favor of retaining, the following conditions

are to be considered when deciding whether to treat the manufacturing of an additional asset at the option of the customer as a separate contract:

a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
b) the price of the asset is negotiated without regard to the original contract price.

In situations when a base contract is entered into together with multiple options to increase the number of goods to be produced, the conditions of ED paragraph 19 and of IAS 11 paragraph 9 for combining the options with the base contract will often be met. In these circumstances, the options and the base contract are accounted for as a single unit of accounting, and the cumulative contract revenues are adjusted accordingly. We are concerned that introducing a 'distinct profit margin' test to the identification of separate performance obligations will prevent accounting for such options together with the base contract. In many instances, the tasks to be performed under the options and the base contract are highly interrelated, with shared costs, a shared risk profile and significantly shared program management, which are themselves inseparable from the risks of the underlying tasks. In most cases, base and option contracts refer to identical products. The asset manufactured under an option contract does not differ significantly in design, technology or function from the asset or assets covered by the original contract. Therefore, we believe that the current accounting treatment consisting of accounting for such options as contract modifications should be retained when the price of the option is negotiated as a single package at the time of entering into the base contract, even when the goods to be produced under the options have distinct profit margins.

Question 3

Do you think that the proposed guidance in paragraphs 25–31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

Answer

The Board guidance with respect to determining when control of a promised good or service is transferred is headed in the right direction; however, we remain highly concerned that, as currently written, the percentage of completion method to account for long-term construction contracts would not be possible in our industry. This method best depicts the economic performance of entities conducting their business through long term production-type contracts.

The Boards' guidance with respect to determining when control of a promised good or service is transferred should be supplemented with the following indicators of contractual relationships that involve continuous transfer of control. Such indicators could be added in a paragraph following Paragraph 31 and could include such factors as the following:

- a long-term period of performance;
- the contract calls for progress or milestone payments as the work is performed;
- the contracted scope of work occupies a significant portion of the contractor's resources;

- the scope of work involves the production of specific, unique assets rather than the mass production of identical assets, as evidenced by the customer's ability to customize the product or service;
- bid conditions include compliance with the customer's specifications and the need to meet these specifications throughout the performance of the contract;
- the customer has ongoing input in specifying major changes (including an ability to issue change orders); or
- Ongoing assessment by both the contractor and the customer of the contractor's progress toward completion of the performance obligation.

Without indicators like those above, contractors may struggle to support continuous transfer of control despite numerous contractual circumstances where continuous transfer of control exists but falls outside the criteria set forth in Paragraph 30.

Although it could be argued that only meeting criteria (d) of ED paragraph 30 is sufficient for continuous transfer of control in circumstances generally found in our industry, we believe the current guidance could be interpreted in a way which could be detrimental to our industry. In practice, ED paragraph 31 could be read literally to require that at least two of the four criteria be satisfied in order for control to be transferred. We do not believe that this is the intention of the Boards. Therefore, ED paragraph 31 should be revised to clarify that the presence or absence of any one or more of the suggested indicators should not be a substitute for an overall evaluation of the facts and circumstances when determining if control has transferred.

Measurement of revenue (paragraphs 34-53)

Question 4

The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

Answer

In our industry, a company must use an estimated selling price (including a variable fee) to make the economic decision of whether or not to enter into a contract. Normally, an entity would not enter into a contractual relationship to produce a good or service without a reasonable estimate of the expected value to be received, including a fee or earnings component. Estimation of the selling price is an essential element of a long-term contract. As such, we agree with the Boards that if the amount of variable consideration can be reasonably estimated, an entity should include it in the measurement of the transaction price that is allocated to performance obligations. However, we do not agree with the

decision making criteria provided in Paragraphs 38 and 39 as we feel these are too prescriptive. Instead, we believe ED Paragraphs 38 and 39 should be eliminated in their entirety and replaced by guidance currently provided in ASC 605-35-24, as follows:

> *"For entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, the presumption is that they have the ability to make estimates that are sufficiently dependable. Persuasive evidence to the contrary is necessary to overcome that presumption. The ability to produce reasonable dependable estimates is an essential element to the contracting business."*

The guidance should require an entity to consider all the relevant factors that affect the transaction price and develop its best estimate based on its experience or on an appropriate forecasting methodology. An entity's experience will almost always provide it with the ability to appropriately estimate a transaction price and reflect the factors that affect the price and only in rare circumstances would an entity be unable to make an estimate. The factors identified in ED paragraph 39 are among the factors an entity will consider when estimating the transaction price (that is, they are elements of the measurement of the performance obligation) but the existence of such factors should not prevent revenue recognition. These same factors are considered by an entity when it negotiates a transaction price with a customer.

We do not agree with a probability-weighted approach in determining the amount of variable consideration that should be recognized. For contracts with variable consideration, the use of a probability-weighted method would lead to recording an amount of revenue that in reality cannot be received under the contract, therefore adding unnecessary complexity. Also, such an assessment of transaction price would lead to a result that would not accurately reflect the underlying economics of the transaction or provide decision-useful information to a user of the financial statements.

We believe that the use of management's best estimate for the measurement of a variable transaction price is much more appropriate. This is the most useful measure as it allows for the exercise of management judgment based on experience to determine the transaction price. It also provides the most decision-useful information for investors as it would reflect the most likely transaction price expected to be received rather than a range of possible, arbitrary outcomes.

In summary, a better approach would be to provide guidance on how uncertainty affects the 'measurement' of the performance obligation (similar to the tentative decision for the revision of IAS 37) and only consider denying recognition of revenues for a given performance obligation in the rare circumstances where a reasonable estimate cannot be made. This would ensure that revenues are always recognized where an entity is able to make a reasonable estimate of the transaction price and will limit delayed revenue recognition only to rare circumstances. The Boards have tentatively agreed on conceptually similar guidance in the lease accounting project.

If an entity is not able to estimate the variable consideration due under a contract, no revenue for the variable part of the arrangement would be included in the amount of the transaction price allocated to the corresponding performance obligations.

Question 5

Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect *how much* revenue an entity recognizes when it satisfies a performance obligation rather than *whether* the entity recognizes revenue? If not, why?

Answer

We do not agree that a customer's credit risk should be reflected in the estimate of the transaction price. We believe that a customer's credit risk should be accounted for as an adjustment to income through bad debt expense and a corresponding allowance for bad debts. We do not believe that recording subsequent cash receipts in excess of the estimated transaction price in income outside of revenue provides decision-useful information. Furthermore, the cost to implement a process to distinguish initial collectability estimates from subsequent changes and ensure appropriate presentation in the financial statements would likely be significant as compared with the benefits of making such a distinction.

Question 6

Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

Answer

Long-term contracts involve the possibility of multiple payments and uncertainty related to the timing of the delivery of goods or services under a contract. These factors affect the assessment and calculation of the time value of money (***TVM***) and may require the use of simultaneous equations. Additionally, if variable elements are present in the arrangement, such as contingent consideration, these calculations may become even more complex. Substantial cost will be incurred in designing and maintaining a system to track and recalculate interest on payments received significantly in advance of or significantly after the transfer of goods or services. This cost would greatly outweigh the benefit to investors and users of financial statements.

We believe that practical accommodations must be introduced and that additional guidance is required on issues such as the discount rate to be used and the requirements for updating (or not) the financial component of the contract upon certain events taking place (such as changes in market interest rates).

A one-year exemption to the application of TVM would avoid the significant burden of tracking a potentially very large number of situations where payments received from customers do not perfectly match the work performed on the related contract. In our view, simply relying on the general application of the materiality concept to avoid the burden of having to track every such situation would not be sufficient. Indeed, where an entity executes numerous contracts at the same time, each

of which contains its own multiple payment scenarios, the mere demonstration of whether the impact is material or not to an entity would be a significant burden.

Therefore, for practical reasons, we propose to add in the final standard a provision that entities be required to compute TVM adjustments only if funding is received greater than one year before or after the planned date of satisfaction of the related performance obligation. The planned date rather than the actual date of satisfaction of the performance obligation should be retained to avoid the issues highlighted in the previous paragraph. The Boards are contemplating conceptually similar accommodation in the proposed lease standard, and a revised approach would be aligned with the on-going practice not to discount current assets and liabilities. With this limited exemption, a substantive financing component embedded in a contract would still be accounted for separately.

In addition, the new standard should clearly state how the discount rate should be established. In our view, a simple and correct approach would be to require that TVM adjustments be computed using the entity's incremental borrowing rate at the time of entering into the contract. This rate should not be updated subsequent to the inception of the contract unless there is a contract modification such that the financing component of the contract is altered. Adjustments to the discount rate for market interest rate movements could require a very significant amount of work with limited corresponding benefits to the users of the financial statements. Our suggested approach reflects the position of the parties at the time the investment and financing decisions were made, at the time of entering into the contract, and is aligned with the proposed approach in the lease project and with how most loans held by manufacturing entities are accounted for under the amortized cost method.

Question 7

Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

Answer

If a contract has a variable transaction price that is not attributable to specific performance obligations, an entity should allocate changes in the transaction price to all performance obligations. The Boards should clarify in paragraphs 50 and 53 that if variable consideration or changes in variable consideration relate to a single performance obligation, an entity should assign that contingent consideration and subsequent changes thereto directly to the specific performance obligation.

Contract Costs (paragraphs 57-63)

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, Topic 330 or IAS 2; Topic 360 or IAS 16; and Topic 985 on software or IAS 38, *Intangible Assets*), an entity should recognize an asset only if those costs meet specified criteria.

Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why not?

Answer

See answer to question 9.

Question 9

Paragraph 58 proposes the costs that relate directly to a contract for the purposes of (a) recognizing an asset for resources that the entity would use to satisfy performance obligations in a contract and (b) any additional liability recognized for an onerous performance obligation.

Do you agree with the costs specified? If not, what costs would you include or exclude and why?

Answer

Our answers to related questions 8 and 9 on costs are combined.

We understand that certain current relevant accounting guidance relating to cost accounting (such as IAS 11 and SOP 81-1) will be replaced by the new revenue standard. We consider accounting for costs to be critical as there is a very significant gap between the current rules under GAAP and IFRS in this respect, specifically the GAAP requirement to charge research and development costs to expense as incurred. We believe that cost accounting should be addressed separately from this project as it is not directly related to accounting for revenues and could diverge from guidance in IAS 2 and IAS 38. Nevertheless, since cost accounting for long-term contracts is a vital consequence of the adoption of the revenue standard, the two projects should be addressed concurrently. In addition, there is an important IFRS/GAAP convergence project currently being deployed, and we strongly suggest that new rules addressing cost accounting be tackled as soon as possible, as this is a major source of differences in accounting between IFRS and GAAP.

We understand that the Boards' project is primarily aimed at clarifying revenue recognition principles and developing a common revenue standard. We appreciate that the Boards have included guidance in the proposed standard for capitalization of set-up and pre-contract costs. However, given that the proposed standard will supersede existing GAAP that specifically supports deferral of certain costs

related to work-in-process on long-term construction-type and production-type contracts, we do not believe the proposed guidance is fully operational or sufficient. In addition, we disagree with the proposed guidance on onerous performance obligations. As written, we believe that it would lead to financial results that are not representative of the duration and complexity of our contracts and the underlying strategy that is involved in customer negotiations.

Until adequate consideration can be given to the accounting for contract costs related to long-term construction-type and production-type contracts, the contract cost guidance included in the proposed revenue recognition guidance should be clarified as relating to set-up costs, and the contract cost guidance included in the existing FASB Accounting Standards Codification should be retained, as follows:

- Subtopic 912-20 Contractors – Construction- Contract Costs: paragraphs 25-5A and 25-6 on program accounting; and
- Subtopic 605-35 Revenue Recognition – Construction-Type and Production-Type Contracts: paragraph 25-9 on average costing for production lots and paragraphs 25-34 to 25-43 on the capitalization of contract costs.

The accounting guidance in these two Subtopics on the accounting for onerous obligations should be retained such that onerous obligations are measured at the program or contract level.

If the Boards decide not to retain current GAAP for the accounting of contract costs related to long-term construction-type and production-type contracts, we believe that the cost guidance contained in the proposed guidance must be revised to allow for the capitalization of contract costs that go beyond initial set-up of the contract.

While we do not object to any of the specified criteria in paragraph 58 for recognizing costs as an asset, we believe that the proposed criteria are incomplete. IAS 38, Intangible Assets, allows for the capitalization of an intangible asset arising from development or from the development phase of an internal project. Development activities that can be capitalized include the design, construction and testing of pre-production or pre-use prototypes and models, among other activities. Intangible development costs are then amortized over the "number of production or similar units expected to be obtained from the asset". For our industry, the ability to capitalize these types of development costs is important for the alignment of the accounting treatment of long-term construction- and production-type transactions between US GAAP and IFRS. We recommend that, prior to issuing a converged revenue recognition standard, consideration be given to the potential disparity of financial results for a company in our industry reporting under US GAAP rather than IFRS, due to the ability of a company reporting under IFRS to capitalize and spread costs that would otherwise be expensed as incurred under GAAP.

The Boards should revise the contract cost guidance as follows, to acknowledge situations where costs incurred might relate to the satisfaction of current as well as future performance obligations:

- clarify the expense guidance in paragraph 59(b) to apply to costs related solely to satisfied performance obligations and eliminate the parenthetical expression "that is, the costs that relate to past performance";

- clarify in paragraph 60 that this guidance relates to costs not capitalized as an asset in accordance with the guidance in paragraph 57; and
- delete the phrase "but do not transfer goods or services to the customer" from example 28 in the Implementation Guidance.

Onerous Obligations

Decision-useful information will not be provided by recording an onerous liability for a performance obligation at the inception of an otherwise profitable contract or program. When losses are expected to be realized on early performance obligations followed by profits on later performance obligations, this implies an improvement in performance that would not represent the contract economics. Conversely, decision-useful information *would* be provided by recognizing losses when a contract has an overall loss position.

We recommend that the onerous performance obligation guidance in Paragraphs 54-56 be revised to require the onerous test be performed at the contract or program level.

Disclosure (paragraphs 69-83)

Question 10

The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

Answer

In their Financial Statement Presentation project, the Boards are considering a requirement for disclosing activity in significant balance sheet accounts, reconciled to the income statement, in the notes to the financial statements. Significant changes in disclosure requirements for revenue and contracts should be determined in the context of the overall benefit and decision-usefulness of financial statements and related disclosures. The information system and personnel costs required to provide activity and reconciliation information exceeds the benefit that might be provided to the users of financial statements. Much of the information required to complete contract balance roll forwards and reconciliations would be tracked outside normal systems and databases, leading to a significant administrative effort and system cost to gather this information.

As stated previously, onerous obligations should not be measured at the performance obligation level. Onerous obligations should be measured at the contract or program level. Quantitative disclosures should be limited to disclosing unusual or infrequent items that would provide additional useful information to financial statement users about the performance of particular contracts or programs.

Qualitative disclosures about sales by contract type or by line of business would be more appropriate and meaningful.

Question 11

The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

Answer

Our industry operates with very long cycles leading to a significant amount of backlog. Various outside factors impact the satisfaction of our backlog. The proposed requirement to disclose the total amount of backlog and the expected timing of its satisfaction would not provide decision-useful information to the financial statement users nor add to the users' understanding of the amount, timing, and uncertainty of revenues and cash flows. This information is likely to be of limited benefit to the financial statements users as it provides only limited information on future revenues, since for most entities, future revenues depend in great part on on-going contract awards. If the Boards view this information as necessary, qualitative disclosure would prove more practical. We believe that existing backlog disclosures included in Management's Discussion and Analysis of Financial Condition and Results of Operations are sufficient and appropriate. The cost of preparing the information systems and procedures to prepare the disclosure contemplated in this question would far outweigh the benefit of the disclosure. We also believe that the disclosure of such information on a quarterly basis would be excessive in terms of the amount of data compilation required to meet such requirements

Question 12: statement of comprehensive income

Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

Answer

An entity should disaggregate revenue into the categories that present how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors. Most companies either already provide such information in their financial statements or disclosures or can provide such disclosures.

Effective date and transition (paragraphs 84 and 85)

Question 13

Do you agree that an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

Answer

Entities should be given the option to apply the proposed guidance retrospectively. The Boards should implement a transition alternative that would permit prospective application for new contracts entered into and materially modified after the date of adoption. Certain revenue recognition standards have been applied on a prospective basis, including AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, AICPA Audit and Accounting Guides for Federal Government Contractors and Construction Contractors, and recently Accounting Standards Update (ASU) No. 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force*.

Retrospective application of the proposed guidance will be costly, burdensome and impracticable. The contract base of our members is composed of tens of thousands of contracts that often span a period of several years. Recasting these contracts to their inception, requiring the revision of quarterly estimates of profitability on a contract-by-contract basis over periods of many years will be very complex and costly. Significant assumptions and estimates occur at numerous times throughout a contract's life. The documentation of these assumptions and estimates is often informal. Retrospective adoption assumes that an entity has information readily available to support historic contract assumptions and estimates, which may not be true and may lead to difficulty making fully informed decisions under the proposed guidance for each past contract and each reporting period. If this information is not available an entity may arrive at a result in the restatement process that will be different from an identical contract accounted for under the proposed guidance from its inception. The processes and systems needed to restate prior period results will probably be different from those involved in accounting for new contracts, leading to increased costs for retrospective restatement. The costs of implementing would be significant but manageable if the proposed guidance were prospectively applied and would lead to better alignment of systems and processes.

We believe the Boards need to consider whether retrospective application is practical. IAS 8, *Accounting Policies, Changes in Accounting estimates and Errors*, provides a definition of 'impracticable' which includes the following conditions:

- the effects of retrospective application or retrospective restatement are not determinable;
- the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or
- the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objective information about those estimates that:

1. provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognized, measured or disclosed; and
2. would have been available when the financial statements for that prior period were authorized for issue from other information.

Retrospective adoption presupposes that an entity has available information for historic contract assumptions and estimates and, as such, can make a fully informed decision under the proposed guidance for each past contract decision point. Absent such information, new assumptions would have to be made and this would inevitably require the use of information that was not available at the time in making these new estimates. Examples of such estimates and assumptions may include the following:

- the initial price allocation to contract performance obligations;
- the amount of variable consideration assumed as contract revenue;
- the allocation of contract costs, if on a different basis;
- the assessment of the timing of transfer of control;
- risk provisioning at the level of each performance obligation; and
- elements related to TVM adjustments.

To the extent historical information is not available, an entity would necessarily compute the restatement in a manner that would be inconsistent with an identical contract being accounted for under the proposed standard from its inception.

To address the Boards' concerns regarding the lack of comparability of financial statements if retrospective application is not mandated, entities should be required to disclose information that enables users of the financial statements to understand the effect of the change in accounting principles. Such disclosures may include some or all of the following items:

- a description of the method of applying the change;
- a qualitative discussion of the entity's major products and services for which revenue recognition under the proposed guidance will be materially different; and/or
- the portion of the entity's revenues and/or earnings in the period that have transitioned to the new accounting method.

The Boards will likely issue new accounting standards on several topics during 2011 and 2012, including revenue recognition, leasing, provisions, fair value measurement and financial statement presentation. We believe that the Boards should address transition to the new accounting standards in the context of the workload that all these changes will require from preparers of financial statements. This consideration should include a realistic assessment of the cost and benefit associated with retrospective rather than prospective implementation.

Implementation Guidance (paragraphs IG1-IG96)

Question 14

The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Answer

1. Implementation examples

The Implementation Guidance provides a small sample of certain possible simple contract transactions that would be sufficient to make the proposed guidance operational. The guidance in BC56 – BC59 addresses how contract management services may affect the identification of performance obligations in a contract. A more complex example that involves the contracting parties' intent should be provided. In addition, the Implementation Guidance should help companies differentiate between normal and abnormal costs including the distinction between these costs. Otherwise, preparers will develop different interpretations of the guidance that could result in a lack of comparability in preparers' financial statements.

2. Contracts with performance obligations or segments covered by other revenue recognition guidance

We believe that the Implementation Guidance needs to address how a contract will be treated under the proposed and other revenue recognition guidance will be treated. For example, if a contract to produce a product also includes financing or leasing terms, would an entity segment the contract or separate the financing or leasing as separate performance obligations?

3. Residual value guarantees

Residual value guarantees (***RVG***s) are common in our industry. RVGs provide protection to the guaranteed parties in cases where the market value of the underlying asset is below the guaranteed value. While RVGs may be arranged between one entity and another entity that is not the customer, these RVGs relate directly to the transfer of a product to a customer and are considered a linked arrangement. The Boards should include guidance in the new accounting standard that other contracts that are linked to a contract with a customer should be assessed by an entity as part of its revenue recognition process.

Similar to warranties in Question 15 below, we believe that RVGs provided in our industry mostly in connection with the sale of aircraft are not separate performance obligations as the conditions in paragraph 23 are not met:

a. they are not sold separately; and
b. they do not have a distinct profit margin.

As these guarantees are not separate performance obligations, the current accrual for estimated costs to be incurred at the time of sale should remain.

Question 15

The Boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with coverage for latent defects in the product. This does not give rise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

Answer

The current accounting guidance is appropriate for a warranty offered by an entity, whether for latent or post delivery defects, when an entity does not separately charge for the warranty. Accruing for the expected cost of warranty coverage at the time of transfer provides decision-useful information to users.

In our industry, we do not believe it is either practical or feasible for an entity to distinguish between warranties for latent defects and warranties for defects that arise after the product is transferred to the customer, even when considering the factors in paragraph B18 (IG18). At the time of sale, we do not have knowledge of defects, and this is supported by the fact that our products must generally go

through rigorous internal and external inspections before they are accepted by the customer. Defects are only known later, when identified and communicated by the customer. The defects identified by the customer thereafter may relate to the original conception of the product or its operation and use after the transfer. Either way, the defects would be covered under the terms of the warranty as long as the product was properly maintained, for the simple reason that it is nearly impossible to dissociate the two. Therefore, we would normally address the correction of such defects without regard to whether the issue arises from a latent defect or a fault that arises after the product is transferred

Despite these facts, the three criteria in paragraph B18 (IG18) seem to indicate that we should distinguish between the types of product warranty, as:

(a) the warranty coverage provided generally exceeds the legal requirement;
(b) our products could technically be sold without this warranty, but it is almost never done as it is an industry practice expected by customers; and
(c) the period of coverage varies based on the individual component and can be fairly lengthy for some components.

Such distinction would not be in line with the way our industry operates, and would be almost impossible to perform given the difficulties in dissociating these types of product warranties.

With respect to accounting for warranties, we believe most warranties provided in our industry in connection with the sale of manufactured products are not separate performance obligations. The conditions in paragraph 23 for being distinct are not met as these warranties:

- are not sold separately for the normal coverage period; and
- do not have a distinct profit margin and are only priced as a bundle for the entire product.

As these warranties are not separate performance obligations, the current accrual for estimated costs to be incurred at the time of sale should remain.

Separately-priced extended warranty coverage, which may be purchased at the discretion of the customer, meets the conditions in paragraph 23 and should be accounted for as a separate performance obligation, with revenue recognized as the related services are delivered.

Question 16

The Boards propose the following if a license is not considered to be a sale of intellectual property:

(a) if an entity grants a customer an exclusive license to use its intellectual property, it has a performance obligation to permit the use of its intellectual property and it satisfies that obligation over the term of the license; and
(b) if an entity grants a customer a nonexclusive license to use its intellectual property, it has a performance obligation to transfer the license and it satisfies that obligation when the customer is able to use and benefit from the license.

Do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed by the Boards? Why or why not?

Answer

The pattern of revenue recognition should not depend on whether the license is exclusive or non-exclusive. An entity has satisfied its performance obligation relating to the transfer of the license once a customer is able to use and benefit from the license. The transfer of the license does not differ simply because a license is exclusive or non-exclusive. If an entity were to recognize revenue evenly over the term of the exclusive license, an entity should then have one or more performance obligations that would need to be satisfied over this term. The Boards stated in their BC that an entity's ability to use would be constrained by an exclusive license arrangement and, as a result, the constraint would be a performance obligation. An alternative view is that an entity selling an exclusive license puts no value on the supposed constraint; otherwise an entity would not have sold an exclusive license.

The Boards noted in their BC that the transfer of an exclusive license is similar to a lease of intellectual property and, as a result, the revenue should be recognized over the term of the exclusive license. In the scope guidance, the Boards indicated that lease transactions are not within the scope of the revenue recognition guidance. If the Boards seek to recognize revenue from the transfer of an exclusive license over the term of the license, exclusive licenses of intellectual property should be addressed as part of the scope of the lease accounting guidance. In addition, if an entity were to sell an exclusive license using a lease contract and such contract were inside the scope of the new leasing standard, we believe that the derecognition model would be applied since the seller would not retain any significant risk relating to the underlying asset.

Consequential amendments

Question 17

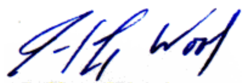
The Boards propose that in accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant, and equipment), an entity should apply the recognition and measurement principles of the proposed revenue model. Do you agree? If not, why?

Answer

We support the Boards' proposal to extend the proposed revenue recognition principles to the sale of nonfinancial interests. The Boards should establish where revenue recognition guidance ends and other guidance begins. The Boards' guidance should indicate whether current accounting standards governing assets held for sale and discontinued operations apply in those situations.

We would be pleased to discuss these comments further with the Boards and their staff.

Respectfully,



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