

GENERAL DYNAMICS

June 10, 2009

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Subject: File Reference No. 1660-100

Dear Mr. Golden:

Thank you for the opportunity to review and comment on the Discussion Paper entitled *Preliminary Views on Revenue Recognition in Contracts with Customers* (the Discussion Paper) issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB and, collectively, the Boards). General Dynamics Corporation is an aerospace and defense contractor with 2008 reported revenues of \$29.3 billion and approximately 93,000 employees. Our primary customers are the U.S. military, other U.S. government organizations, the armed forces of other nations, and a diverse base of corporate, government and individual buyers of business aircraft. We typically operate under long-term contracts for the design, development, production and support of complex, highly engineered products and related services. Many of these contracts involve decades-long interaction between the customer and the contractor. In this context, we apply the revenue recognition model prescribed in the American Institute of Certified Public Accountants' (AICPA) Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-type and Certain Production-type Contracts*, as well as the AICPA Audit and Accounting Guide, *Federal Government Contractors*.

We support the Boards' efforts to simplify the complex framework of revenue recognition standards currently in place under U.S. Generally Accepted Accounting Principles (U.S. GAAP), and we agree that the goal of a single standard for revenue recognition across all industries is a worthy objective. However, we are concerned that this approach runs the risk of creating a framework that is suboptimal for all rather than a collective improvement. It appears to us that the Boards share this concern given the fact that the Discussion Paper scopes out certain industries for which the proposed model may inappropriately distort reported financial results.

In particular, we believe the existing literature applicable to the long-term contracting environment is mature; well-established; understood by issuers, regulators and the investment community; fits our business model; and appropriately reflects the economic substance of the contract and the customer relationship. We believe the Discussion Paper as drafted, when applied to the long-term contracting environment, will result in financial statements and disclosures that distort the economic relationship between the contractor and the customer and will produce information that is not decision-useful for the investment community.

Accordingly, we propose two alternative approaches to preventing the unintended consequences that may come with a single standard. The first is for the Boards to consider reducing the current revenue

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recognition framework to two or three models rather than just one, including a separate model for the long-term contracting environment. For the reasons articulated below, we believe the long-term contracting environment is sufficiently unique to warrant a separate standard, consistent with the current approach under International Financial Reporting Standards (IFRS). Under this approach, the Boards could focus on convergence of SOP 81-1 with International Accounting Standard (IAS) 11, *Construction Contracts*, and other U.S. GAAP revenue recognition models with IAS 18, *Revenue*.

Alternatively, we recommend the following modifications and/or additional interpretive guidance to clarify the application of the Discussion Paper to the long-term contracting environment. If these concerns can be resolved, we believe the one-model approach can adequately produce financial information that is useful for stakeholders in our industry without imposing impracticable cost, time, systems and personnel burdens on the reporting companies.

Identifying the Unit of Account

One of the key principles of the existing long-term contracting model is the notion that the contract is presumed to be the profit center, or unit of account. This approach ensures that the recognition of revenue and earnings matches the economic bargain reached between the contractor and the customer. Acknowledging that contracts can be subject to form-over-substance risks, the current framework provides an appropriate basis for either segmenting or combining a contract or series of contracts where the form of the contract does not match the economic substance of the arrangement.

While long-term contracts are often complex and involve a number of phases, including design, development, low-rate production, full-scale production and follow-on support activities, the contract is typically negotiated from the perspective of both the contractor and the customer as a single program with an overall profit objective. Given common conditions of set-up costs, early-stage development costs and labor learning curves, bifurcation of a contract into sub-elements would result in either a disproportionate amount of revenue being attributed to substantially similar activities and deliverables over the life of the contract, or the recognition of losses early on in contract performance despite the fact that the contractor reasonably anticipates full recovery of costs and recognition of a profit on the contract as a whole.

In addition, dividing long-term contracts into “performance obligations” as suggested in the Discussion Paper would likely be arbitrary and inconsistently applied across contractors. It is not clear whether the contract should be divided by performance phase, contract line-item number (CLIN), task order or even individual dollars of cost incurred at the extreme (given that the U.S. government frequently expressly reimburses the contractor for costs incurred plus a negotiated profit). Further, because the contract scope of work is highly customized to the customer’s specification and frequently has no substitute buyer, and because the individual elements of the contract are typically not bid separately, there is no evidence available to determine an appropriate assignment of contract consideration to the various performance obligations. Therefore, the requirement to separately measure the value of each performance obligation would be onerous, arbitrary, inconsistently applied and not representative of the economic arrangement. Of further concern is the Discussion Paper’s lack of discussion of circumstances in which it is appropriate to combine multiple contracts into a single profit center.

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Thus, we recommend that the Discussion Paper be modified to presume that the contract is the basic unit of account and to provide guidance on when it is appropriate to overcome this presumption by either segmenting or combining a contract or group of contracts. This guidance could borrow from the concepts in SOP 81-1 and IAS 11. This model could be modified by making the combining and segmenting decisions mandatory if the respective criteria are met rather than voluntary as suggested by SOP 81-1.

Timing of Revenue Recognition

The second major underpinning of the existing model for long-term contracting is the notion that reporting revenues and earnings as the work progresses (i.e., the percentage-of-completion method) best reflects the economic activity of the contractor. This approach is based on the precondition that (1) the arrangement between the parties clearly specifies the enforceable rights of each and the consideration to be exchanged, (2) the customer can be expected to satisfy his obligations under the contract and (3) the contractor can be expected to perform his contractual obligations.

The approach proposed in the Discussion Paper seems to take the opposite position, suggesting that revenue be recognized after the fact, only when “control” of the contract asset has passed to the customer. This approach gives no credence to the contractual relationship that has been established and the reasonable expectations of both parties to the contract. Unless a contractor’s performance can be considered a continuous transfer of control, the proposed approach will likely lead to a predominance of revenue recognition at completion of the contract effort. For a variety of reasons, this proposed approach would result in inconsistent results that again do not reflect the economic activity of the contractor or the economic substance of the arrangement reached between the contractor and customer.

We believe the concept of continuous transfer of control can be easily met for U.S. government contracts within the current language of the Discussion Paper. U.S. government procurement regulations generally provide the government rights to intellectual property resulting from development-stage contracts, and government contract progress payment terms provide for continuous acceptance of contractor work performed. Thus, it appears that U.S. government contracts could follow the percentage-of-completion method under the proposed model.

However, the long-term contracting environment is not limited exclusively to arrangements with the U.S. government. As such, any contracts with commercial customers or international governments that do not have terms similar to U.S. government contracts would default to a model that would more closely resemble the completed-contract method. This would be the case even in the extreme circumstance that substantially identical products are produced over the same periods for two customers – the U.S. government and an international government – with two drastically different revenue recognition models. We are concerned that this would result in a revenue recognition model that is based more on the form of the contract than on the substance of the arrangement between the parties. This may even lead contractors to modify terms of their contracts to manipulate the revenue recognition model they can apply.

To clarify this ambiguity and prevent either inconsistent, nonsensical results or manipulation of form over substance, we propose additional guidance be provided to clarify when control of the contractual asset passes to the customer, in particular clarifying when control is transferred continuously. In the long-term

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contracting environment (both with the U.S. government and other government and commercial customers), the products and services provided are generally highly customized to the customer's specifications. In fact, the customer is typically on site (or vice versa) in an integrated arrangement with continuous oversight and participation in the contractor's scope of work. This frequently results in mid-stream changes to the scope of work and other modifications to the contract dictated by the customer. In addition, the high level of customization results in products defined by and usable only by the specific customer that has contracted for the work. Thus, the customer has exercised control over the scope even before work commences and continues to do so throughout the contract term. We believe these circumstances (the high degree of customization and the limited customer population) are indicative of continuous transfer of control and should be considered indicators of such in the Discussion Paper. In addition to adding these specific characteristics in the Discussion Paper's guidance, we believe the Board should make it clear that no one indicator of transfer of control is determinative, but all factors should be considered.

Measuring Progress

Assuming it can be resolved that performance obligations in long-term contracts are satisfied via a continuous transfer of control as discussed above (i.e., a percentage-of-completion model is appropriate), the question that arises is how best to measure progress toward completion. We agree conceptually that, where they can be established and monitored objectively and reliably, output measures are the most direct measure of progress toward completion. Indeed, this is consistent with current practice under SOP 81-1. However, we also acknowledge that any measure, input or output, is merely a proxy for actual progress toward completion, and each has costs and benefits. For the reasons outlined below, we believe that costs incurred should be endorsed as a reasonable proxy for progress toward completion on long-term contracts where reliable, representative output measures cannot be determined.

Unfortunately, output measures are frequently difficult to define and measure on long-term construction and production-type contracts. These contracts often involve few, large deliverables over a protracted contract term. In other cases, there may be a large number of deliverables that are back-end loaded in the contract term even though the contractor has made significant progress toward completion of the total contract effort before the first unit is delivered. As a result, input measures, particularly costs incurred, are the predominant measure of progress used and generally produce the most decision-useful information that reflects the underlying economics of the contractor and the contractual relationship.

In the context of doing business with the U.S. government, the customer explicitly or implicitly reimburses the contractor for its costs incurred plus a negotiated (fixed or variable) fee. This is true for cost-reimbursable contracts, in which case the customer performs audits of costs incurred and explicitly pays the contractor for allowable, reasonable costs incurred. This is also the case with respect to fixed-price contracts. While the government is explicitly paying a price for a specified scope of work, the contractor's cost experience is subject to scrutiny in the form of government reviews of cost or pricing data as dictated by the Truth in Negotiations Act. In addition, government contracts (both cost-type and fixed-price) are subject to possible termination for the convenience of the customer, in which case the government pays the contractor for costs incurred plus a reasonable profit. For these reasons, from both the contractor's and the customer's perspective, cost incurred is frequently the most direct and meaningful measure of progress toward completion.

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Example 5 in Appendix A to the Discussion Paper indicates that the use of input measures is not acceptable because the extent of progress can be distorted in cost-overrun situations. We find this conclusion troubling because it presupposes that the contractor knew a cost overrun (or under-run) would occur before effort on the contract commences. Presumably, the contractor would choose the appropriate measure of progress at the outset of the contract and use it consistently throughout the contract term (and consistently across similar types of contracts). In addition, the example presumes that the cost overrun (and, thus, the presumed distortion of progress toward completion) results exclusively from costs incurred to date in excess of expected costs. In most cases, however, changes in estimated costs at completion result from a combination of costs incurred to-date and costs expected to be incurred in the future in excess of originally anticipated costs. In fact, it is common for the majority of the cost growth associated with a change in estimate to be associated with to-go costs (whether caused by unanticipated material or commodity cost growth or changes in labor learning curve assumptions that affect projected costs of future performance).

Further, for cost-reimbursable contracts, the use of measures of progress other than costs incurred would likely result in significant distortion of the contractor's economic condition under the contract in cases of cost overruns and under-runs. Using the methodology recommended in Example 5, a contractor could report a loss in a given reporting period on a cost-reimbursable contract due to a cost overrun despite the fact that the contractor will fully recover the additional costs under the contract. For these reasons, we disagree with the statement in Example 5 that the use of costs incurred as a measure of progress is not appropriate.

It may be appropriate to define certain exceptions for costs incurred that do not represent progress toward completion, consistent with current practice under SOP 81-1. These might include advance procurement and staging of materials prior to construction or production and advance payments to subcontractors prior to commencement of work. Such exceptions can be clearly defined and understood; they appropriately reflect the underlying economics of the contract performance; and they can be accommodated by existing systems and internal controls put in place by contractors. We do not believe that such exceptions should preclude the use of a reasonable proxy for progress toward completion that reflects the contractor's underlying economic circumstances, is effective and efficient to manage and monitor, and is consistent with the contractual relationship of the parties.

Contingent Revenues

Another common feature of long-term contracts is the requirement to estimate revenues at completion. This includes a variety of "contingent" sources of revenue, such as award and incentive fees, change orders and modifications, and claims and requests for equitable adjustment. Contractors' demonstrated ability to estimate extends to both costs and revenues, and fundamental to a faithful representation of the economic activity under long-term contracts is the recognition of the contractor's best estimate of uncertain revenues.

We believe the model proposed in the Discussion Paper prohibiting (1) the recognition of revenue until it is no longer contingent and (2) the remeasurement of contract revenues in circumstances other than onerous contracts will lead to reported results that do not reflect the economic arrangement between the

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parties and distort revenues and earnings with perturbations that do not reflect the economic activity of the period.

The various types of contingent revenue commonly represent a substantial component of long-term contracts, and as such, contractors include in their pricing decisions an estimate of the expected capture rate for these items. These judgments are based on the contractor's history with similar types of work scope and interaction with the customer and are fundamentally no different than the judgments required to estimate costs expected to be incurred in the performance of a contract. Therefore, we propose that revenue recognition be based on the contractor's best estimate of the likely outcome of all revenues and costs, contingent and otherwise. (This could be achieved by defining characteristics, such as those described above, that make a "contingent" revenue source no longer contingent.) Further, we recommend that estimated revenues and costs be remeasured on a regular basis to reflect management's best estimate of the expected economic outcome of the contract.

Contract Costs

The final critical element in the current model for long-term contracts is the notion that contracts are profit centers, not revenue centers, and that contract costs should be recognized in proportion to contract revenues to report periodic sales and earnings based on the contractor's anticipated profits at completion of the contract. Fundamental to this model is the notion that costs are identifiable and assignable to specific contracts and that these costs, taken together with contract revenues, determine the profits to be recognized in connection with each unit of account, or profit center (i.e., the contract).

This is most strikingly the case with respect to U.S. government contracts, where as noted above, the customer is explicitly or implicitly reimbursing the contractor for his costs incurred, including even such items and general and administrative costs, state taxes and a cost of capital burden. Even many international government procurement regulations recognize the explicit or implicit reimbursement of a contractor's costs incurred.

Separation of revenue recognition from cost recognition in a long-term contracting environment can result in wild swings in profit recognition for a given contract and even loss recognition in early phases of a contract despite the explicit reimbursement of these costs and the anticipation of profit recognition at completion of the contract. This could severely distort reported financial results and even lead to shareholder lawsuits if shareholders were to sell shares following periods of reported losses only to have the shares rebound after the subsequent profits are reported. For these reasons, we are highly uncomfortable with the notion of decoupling the recognition of contract revenues from contract costs. Therefore, we believe that any standard that addresses accounting for revenues under contracts with customers must also address the accounting for the related contract costs.

Conclusion

In summary, we continue to support the Boards' initiative to improve the existing revenue recognition framework. However, we believe the proposed single model approach may have more unintended negative consequences than improvements, particularly for the long-term contracting environment.

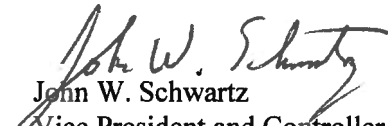
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Therefore, we propose that the Boards either develop a separate standard for long-term contracts with the goal of achieving convergence with IAS 11, or provide modifications or additional guidance to the proposed model to eliminate the anomalies outlined above.

If these concerns are not addressed, the proposed model would result in financial information that is inconsistent with how contractors bid and manage contracts, how we interact with customers, how the investment community understands our business and the fundamental economic substance that underlies our operations. This would require the maintenance of parallel financial systems and significant non-GAAP disclosures to reconcile the reported results with information that investors can understand and use to make informed decisions.

Again, we thank you for the opportunity to express our thoughts on the proposed Discussion Paper, and we welcome the opportunity to discuss these issues further.

Very truly yours,



John W. Schwartz
Vice President and Controller