

BAE Systems plc
6 Carlton Gardens
London
SW1Y 5AD

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

19 June 2009

Dear Sir/Madam

Discussion Paper – Preliminary Views on Revenue Recognition in Contracts with Customers

I am pleased to submit the comments of BAE Systems plc on the Discussion Paper above.

BAE Systems plc is a global defence, security and aerospace company delivering a full range of products and services for air, land and naval forces, as well as advanced electronics, security, information technology solutions and customer support services. With 106,400 employees worldwide, BAE Systems' sales exceeded £18.5bn in 2008.

As required of any company listed on the UK stock exchange, BAE Systems prepares its consolidated financial statements in accordance with EU-endorsed IFRS.

Introduction

This comment letter does not attempt to respond to all of the questions raised by the Board in the Discussion Paper. Instead, we have focused on the Discussion Paper's fundamental principle that revenue is recognised when the promised assets are transferred to the customer and, in particular, its application to the long-term contracting environment, which is of particular importance to a major contracting company like BAE Systems. Consequently, this comment letter addresses questions 1, 2, 8 and 9.

We acknowledge that the two current standards on revenue recognition are based on inconsistent principles – IAS 11 *Construction Contracts* is based on contract activity, whereas IAS 18 *Revenue* is based on the transfer of risks and rewards for the sale of goods, and contract activity for the sale of services – and, in general, recognise the potential benefits of the Board's intention to introduce a single, principle-based revenue recognition model.

However, we are concerned that a strict, legalistic/rules-based interpretation of the Board's proposed revenue recognition model, which focuses on the legal transfer of control in contracts, may not provide the users of financial statements with decision-useful information, particularly in respect of long-term contracts.

In particular, the concept of continuous/non-continuous transfer of control is key to the Board's proposals, but not well explained in the Discussion Paper. The Board should,

therefore, expand upon this concept in order to provide more clarity around the application of the Discussion Paper's proposals to the long-term contracting environment.

Current accounting practice

We are engaged in a large number of significant and complex contracts of a multi-year nature which are currently accounted for under a form of the percentage of completion method in accordance with IAS 11. Sales are recognised when title passes or a separately identifiable phase (milestone) of a contract has been completed. Sales milestones must relate to demonstrable progress on a contract. As stated in IAS 11 (25), "*this method provides useful information on the extent of contract activity and performance during a period*". We concur with this view and consider our application of the requirements of IAS 11 to reflect good accounting practice.

The existence of a separate accounting standard dealing with revenue recognition on long-term contracts specifically is an indication that they are fundamentally different in nature to the transactions accounted for under IAS 18. In BAE Systems, IAS 11 accounting practice is embedded, well understood and results in the recognition of revenue in accordance with the economic reality of the progress on a contract.

Proposed revenue recognition model

The Board is proposing a contract-based revenue recognition model based on changes in the net contract asset or liability. We note that the Discussion Paper does not clearly define contract assets and liabilities and would, therefore, recommend that this is clarified in advance of the publication of the Exposure Draft.

Our understanding of the key proposed revenue recognition principles set out in the Discussion Paper is as follows:

- revenue is recognised when a contract asset increases or a contract liability decreases;
- a contract asset increases or a contract liability decreases when a performance obligation is satisfied;
- performance obligations are satisfied when goods are transferred to the customer; and
- goods are transferred to the customer when the customer controls the goods, usually when they take physical possession of the goods.

Critically, the Discussion Paper proposes a model that would recognise revenue upon the transfer of promised goods, rather than the activities of the entity producing those goods. The activities that an entity undertakes in fulfilling a contract would only result in revenue recognition at the time of those activities if they simultaneously transfer assets to the customer.

Issues raised by the proposed model

A strict, legalistic/rules-based application of this principle to long-term contracts raises the following issues:

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- irrespective of whether or not assets are transferred simultaneously to the customer, the profile of revenue recognition would not necessarily be in line with the activities of the entity that have been undertaken to fulfil the contract, which is the principle that underpins IAS 11 and, we would argue, should be the objective of any new revenue recognition standard in relation to long-term contracts;
 - in the event that an asset under construction for multiple years is only transferred to the customer at the end of the construction period, the recognition of all of the revenue, and presumably the associated profit, at the end of that period, which could be during an accounting period in which only a small proportion of the activities relating to the contract have been performed, would provide misleading information for users of the financial statements. The provision of decision-useful information should be the overriding objective of any new standard; and
 - a focus on the contractual transfer of control could lead to revenue recognition in advance of the entity's activities undertaken to fulfil the contract where, for example, effective control is transferred to the customer upon purchase of raw materials for the contract by the manufacturer. This would lead to a more aggressive profile of revenue recognition.

We would argue, therefore, that it is the Discussion Paper's focus on the legal transfer of control in contracts, rather than the activities of the entity undertaken to fulfil the contract, that could lead to a significant and undesirable change to existing accounting practice in respect of long-term contracts. As a result, the users of financial statements would have less decision-useful information available to them than under existing accounting standards.

We also note that the Discussion Paper does not attempt to consider certain areas which are particularly relevant to long-term contracts, such as profit recognition, and changes in contracting terms and conditions, including contract variations and amendments. These represent some of the complexities of real long-term contracts.

Understanding of the transfer of control

The Board should expand upon its definition of the transfer of control in order to clarify how the principles in the Discussion Paper could be applied to the long-term contracting environment in a way that provides decision-useful information.

At this point, it is worth summarising how the Discussion Paper defines the transfer of control.

The Discussion Paper states that, typically, the customer controls the good when it takes physical possession of the good. It goes on to say that an exception might be certain bill and hold arrangements, but concludes, that, in essence, it is the receipt of the goods by the customer that satisfies a performance obligation and, hence, allows revenue to be recognised. In relation to long-term contracts, the Discussion Paper states that assets must be continuously transferred to customers to allow revenue recognition.

It is only by way of examples 5 and 6 of Appendix A in the Discussion Paper that the Board considers further how this concept might be applied to the transfer of assets in long-term contracts in practice.

The concepts indicated by examples 5 and 6 should be developed further by the Board and included within any future standard to help preparers to decide whether in economic substance, if not in strict legal form, control is continuously transferred to the customer during the construction period.

The Board should give consideration to the following examples of indications of control transferring continuously in contracts where physical possession and/or legal title do not transfer to the customer until completion:

- the customer can take over the partially completed asset at any time during the construction period and engage another contractor to complete it;
- in the event of cancellation by the customer during the construction period, the customer is liable to pay the contractor for the amount of work performed up to that time;
- the asset is a unique design specifically to the customer's specifications and, therefore, cannot be sold by the manufacturer to other customers. This is consistent with IFRIC Interpretation 15 *Agreements for the Construction of Real Estate*, which considers how to determine whether agreements for the construction of real estate are within the scope of IAS 11 or IAS 18. Under IFRIC 15, an agreement for the construction of real estate meets the definition of a construction contract when the buyer is able to specify the major structural elements of design before construction begins or specify major structural changes once construction is in progress;
- the manufacturer does not have the ability to unilaterally scrap materials purchased for the construction contract without authorisation from the customer; and
- the customer includes the partially completed asset on its own balance sheet as construction progresses.

The provision of more clarity around the Board's definition of its concept of control, and continuous/non-continuous transfer of control, could help to ensure that any new standard based on the principles underpinning the Discussion Paper would recognise revenue in line with contract activity and provide decision-useful information in respect of long-term contracts. This is not meant to be an exhaustive list and, therefore, the Board should consider further indicators of the transfer of control to help preparers to apply the principles in practice.

Other considerations

In the event that the new requirements do not provide decision-useful information regarding the in-year financial performance of long-term contracts, companies may choose to present their management accounts under existing accounting standards. This could lead to differences between the reporting of performance in management accounts, which are used internally for decision-making purposes, and statutory accounts.

Implementation of the new standard as it stands would be costly in terms of management time and require accounting system changes to cope with the new requirements with no additional benefit to the users of financial statements.

The Board should consider the potential impact of its proposals on the profile of government tax receipts in the event that all revenue, and therefore profit, is only recognised at the end of certain multiple year contracts.

Conclusion

We recognise the potential benefits of the Board's intention to introduce a single, principle-based revenue recognition model.

However, the Board's proposed model is based on the principle that revenue should be recognised solely upon the transfer of control of goods, rather than the activities of the entity producing those goods. The existing revenue recognition standards, although apparently inconsistent in terms of underlying principles, broadly achieve this and, therefore, provide the users of financial statements with decision-useful information.

Strict, legalistic/rules-based application of the principle as proposed in the Discussion Paper to certain long-term contracts could lead to the recognition of revenue at the end of a multiple year contract or in advance of current practice under IAS 11. This would not provide the users of financial statements with decision-useful information and, therefore, the Discussion Paper's proposals would not satisfy the fundamental objective of a set of financial statements.

In order to apply the Discussion Paper's principles to the long-term contracting environment in practice and provide decision-useful information, the Board should expand upon its definition of the transfer of control and, in particular, the concept of continuous/non-continuous transfer of control.

The Board should, therefore, provide guidance in any resulting standard based on an expansion of the Board's comments in examples 5 and 6 of the Discussion Paper to help preparers to decide whether in economic substance, if not in legal form, control has been transferred to the customer during the construction period. The objective of this should be to ensure that revenue is recognised on most long-term contracts in line with contract activity without introducing rules specific to long-term contracts and, therefore, not achieving the Board's admirable goal of a single, principle-based model.

The implementation of a new standard on revenue recognition based on the Discussion Paper as it stands would provide potentially misleading information to the users of financial statements, whilst also requiring a significant amount of management time and add real cost to businesses.

We would be more than happy to meet with you should you wish to discuss our comments contained in this letter.

Yours faithfully

Matthew Turnor
Director of Group Reporting