October 18, 2010

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

Subject: File Reference No. 1820-100

Dear Mr. Golden:

Thank you for providing the Aerospace Industries Association (“AIA”) and our individual members an opportunity to review and comment on the proposed revenue recognition standard outlined in the Exposure Draft entitled, Revenue Recognition (Topic 605), Revenue from Contracts with Customers (“the Exposure Draft”), issued by the Financial Accounting Standard Board (FASB or “the Board”). AIA is the premier aerospace industry trade association representing the nation’s major manufacturers of commercial, military and business products such as aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment. AIA represents almost 300 manufacturing companies with over two million employees and contributes $57 billion to our nation’s trade surplus. Many of our industry’s companies are major suppliers to the U.S. Government.

In our industry, we enter into arrangements with customers to provide highly customized, complex engineering, design, and manufacturing services over extended periods. These arrangements are usually with an individual customer (principally the U.S. Government) and are generally priced based upon estimated costs plus a reasonable margin for the risks we assume in the contract. We believe that our industry is unique and our contracts embody many different complexities that simply do not exist in many other industries, such as claims; penalties; incentive/award fees; change orders; options/additions; combining and segmenting. The current revenue recognition model provided under Accounting Standards Codification (ASC) 605-35, Revenue Recognition, Construction-Type and Production-Type Contracts (ASC 605-35), is well established and understood by investors in our industry, as it aligns with how our contracts are bid, negotiated and managed. The guidance established by ASC 605-35 contains both revenue and cost guidance for the unique attributes of our industry that does not exist elsewhere in accounting principles generally accepted in the U.S. or other jurisdictions that would be eliminated when the new guidance is adopted. This guidance has stood the test of time, having been in use for nearly thirty years. Therefore, we reiterate our request that long-term construction/production-type contracts be exempt from the proposed standard and that the current ASC 605-35 guidance be retained. If long-term construction/production-type contracts
cannot be scoped-out of the proposed standard, we recommend that the Board retain the existing guidance in ASC 605-35 and ASC 912, Contractors- Federal Government, for costs associated with contracts and programs.

As an alternative to the above, we respectfully request that consideration be given to clarifying or modifying the guidance to address our specific concerns outlined in Attachment I to this letter. We believe these modifications are necessary to ensure that the accounting model for our industry appropriately reflects the economic substance of our arrangements with customers and provides decision-useful information to our investors. While we believe the Board has made significant progress in addressing our industry’s concerns regarding the ability to apply a single revenue recognition model to every contractual arrangement, significant operational challenges remain. Our primary concerns include:

- **Contract segmentation and identification of performance obligations** – 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 purposes of evaluating whether an entity shall combine two or more contracts, the Board provides 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 Board’s intent as described in BC36 to provide suggestive indicators of price interdependence. However, for purposes of evaluating whether an entity shall segment a single contract, the Board has provided two conditions that are effectively a prescriptive, quantitative test, as illustrated in paragraph IG2. 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 and produce information that is not decision-useful. We believe the best approach to clarifying the segmenting guidance is to integrate segmenting of contracts and identification of performance obligations into a single step performance obligation determination.

- **Continuous transfer of control** – Proportional or percentage of completion revenue recognition is important in our industry. We believe the current language in the Exposure Draft does not provide sufficient guidance with respect to when continuous transfer of control exists. We believe the Board should provide indicators of contractual relationships that are evident in a continuous transfer of control model. Absent such indicators, contractors have no support beyond the guidance in paragraph 30(d) for supporting continuous transfer of control despite the fact that there are numerous contractual circumstances not addressed by 30(d) that further support the continuous transfer model. We also note that the control indicators in the proposed standard have limited relevance for service contracts.

- **Contract costs** – We appreciate that the Board has included guidance in the proposed standard for capitalization of contract costs that are incurred in satisfying performance obligations. This is particularly critical given that the proposed standard would eliminate ASC 605-35, which specifically supports deferral of certain costs related to work-in-process on long-term construction / production-type contracts. However, we do not believe the proposed guidance, as written, is operational or sufficient. As written, we
believe that the proposed guidance would lead to financial results that are not representative of the duration and complexity of our contracts and the underlying relationships that exist with our customers. We believe that the proposed guidance for contract costs needs to be enhanced to make the standard operational and to ensure that the resulting accounting appropriately reflects the underlying economics of long-term construction/production-type contracts. Specifically, we believe costs incurred to fulfill current performance obligations should be assessed to determine whether a portion of the cost should be capitalized rather than expensed if the cost clearly benefits future periods and thus can be deemed to meet the definition of a contract asset. To this end, the cost guidance should be expanded to permit fulfillment costs to be averaged over multiple units within a contract and, in appropriate circumstances, across multiple contracts or reasonably expected contracts.

- **Variable consideration** – We agree that an entity should recognize revenue based on an estimated transaction price in the appropriate circumstances. However, we do not agree with a probability-weighted approach in determining the amount of variable consideration. When estimating the transaction price for a contract with variable consideration, the use of probability-weighted amounts, especially when there are binary outcomes, likely would lead to recording revenue at an amount that is not a possible outcome under the contract. The approach adds unnecessary complexity to the assessment of transaction price for a result that would not accurately reflect the transaction price and underlying economics of the transaction or provide decision-useful information to an investor. Therefore, we support the use of management’s best estimate for the measurement of a variable transaction price. We believe that management’s best estimate is the most useful measure, as it allows for the exercise of 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 averaging a range of possible, potentially arbitrary outcomes.

- **Onerous performance obligations** – We believe that recording an onerous liability for a performance obligation at inception of an overall profitable contract or program does not provide decision-useful information. We understand the Board feels it is preferable to apply the onerous test at a performance obligation level to ensure timely reporting of adverse changes in circumstances. However, if a seller enters into a contract or program expecting to incur losses on certain performance obligations within that contract or program that will be offset by other profitable performance obligations within that contract or program, we do not believe up-front recognition of the loss would faithfully depict the expected economic outcome on the contract or program. Rather, it would be useful to investors to understand when, at the contract or program level, due to cost overruns or unanticipated production issues, the contract or program has fallen into an overall loss position. Therefore, we recommend that the onerous test be performed at the contract or program level, as this would truly represent an adverse change in circumstances for which a liability should be recorded and the change in circumstances should be disclosed in the financial statements.

- **Time value of money** – We are not opposed to the notion of adjusting the amount of promised consideration in a contract to reflect the time value of money. However, we believe this bifurcation should be limited to specific circumstances in which the
contracting parties intended for a portion of the consideration to represent transaction financing. To this end, we ask the Board to modify the proposed guidance to require consideration of the substance and intent of the parties in determining whether time value of money is a factor in a contract. In many contracting situations, contract prepayment terms are designed to protect the financial interests of the contractor (e.g., sound business practice to get an up-front advance as a security deposit), but not as a financing mechanism. We believe the standard should require clear evidence of the intent of the parties to include a financing mechanism in the contract as a requisite to the application of the time value of money principle.

- **Transition** – We do not agree that the proposed guidance should be applied retrospectively due to the impracticality and limited benefit of such restatement. As an alternative, we suggest that the proposed guidance be applied prospectively for contracts with customers entered into after the effective date of the standard. Other major revenue recognition standards have been applied on a prospective basis, including most recently Accounting Standards Update (ASU) No. 2009-13, *Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force, and Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements that Include Software Elements*. To address the Board’s concern regarding the preservation of trend information about revenue, we suggest that entities be required to disclose information that enables users of the financial statements to understand the effect of the change in accounting principle in the spirit of ASC 250, *Accounting Changes and Error Corrections* (ASC 250).

- **Disclosure** – In our view, the effort to provide the significant additional quantitative disclosures and tabular reconciliations of balance sheet amounts described in the Exposure Draft would significantly outweigh the benefits provided to our investors. As the proposed model will apply across all industries, we do not believe prescriptive disclosures are beneficial given the substantial differences across business models. We suggest requiring disclosure using a principles-based approach, as opposed to prescriptive disclosures that may not be meaningful to financial statement users. A principles-based approach would allow preparers to provide quantitative information they deem necessary to support the qualitative descriptions of their contract activities. In this manner, different industries would be able to provide relevant information to their respective financial statement user groups. We believe the disclosure principle in the proposed standard needs to weigh three key elements: 1) the benefits investors will receive versus the cost to provide the disclosures; 2) the level of disaggregation of quantitative disclosure information and principles to determine that level; and 3) when non-financial or forecast data should be included in the required disclosures and the related impact on audit firms and the safe harbor protections for forward-looking statements afforded under the Private Securities Litigation Reform Act of 1995 (PSLRA) and related U.S. Securities and Exchange Commission (SEC) regulations.

For your convenience, we have included the original Exposure Draft questions in Attachment I followed by our response to each question. We did not respond to questions for which we have no industry-specific observation or concern based on our current business or industry practices. We appreciate the opportunity to present our views on this subject and welcome the opportunity to meet with you in person to review them. Thank you in advance for your consideration of our comments.
Best regards,

Richard K. Sylvester
Vice President
Acquisition Policy

Attachment
As stated
ATTACHMENT I

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 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?

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 purposes of evaluating whether an entity shall combine two or more contracts, the Board provides 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 Board’s intent as described in BC36 to provide suggestive indicators of price interdependence. However, for purposes of evaluating whether an entity shall segment a single contract, the Board has provided two conditions that are effectively a prescriptive, quantitative test, as illustrated in paragraph IG2. 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.

We believe the Board included the segmentation guidance to prevent reallocations of variable transaction price across multiple performance obligations when those performance obligations are priced independently. We agree with the Board’s concern; however, we do not believe that the proposed segmentation guidance will achieve its intended purpose. We recommend that the Board consider eliminating the guidance on segmentation and provide further guidance on allocating transaction price to specific performance obligations. This would eliminate the guidance in paragraphs 15 and 16 and amend paragraph 50 to require an estimate of contingent consideration that relates to a specific performance obligation, or subset of obligations, to be initially allocated to that performance obligation(s). Paragraph 53 would also need to be amended to require subsequent changes in transaction price that relate to a specific performance obligation, or subset of obligations, to be allocated to that performance obligation(s). Given the direction the Board has taken with respect to accounting for revenues at the performance obligation level, we do not believe it makes sense to “spread” changes in transaction price across all performance obligations regardless of whether the performance obligations were priced independently.

We considered several alternative solutions to address the issues we have identified in the segmenting guidance, but none results in the comprehensive, holistic modifications proposed above. These included the following:
• Modifying the indicators of price independence to more suggestive, qualitative considerations, including whether the customer had the option to select some of the deliverables individually or as a whole; and whether the price and/or performance of a one deliverable has an impact on the others.

• Clarify the application of paragraph 15(a) to deliverables from the perspective of the contractor in the buyer-seller arrangement in question (and not at any sub-tier supplier/subcontractor level). This would also require clarification of the applicability of paragraph BC56 to the segmenting decision in addition to the separation of performance obligations.

Because these approaches did not solve the issues with initial and subsequent allocation of transaction price in paragraphs 50 through 53, we concluded that they were inferior to the solution proposed above.

Finally, we agree with how the pricing principle is applied to contract modifications. However, we recommend that paragraph 18 be modified to require that a contract modification must meet the conditions in both paragraphs 9 and 10 in order to be combined with the original contract. We believe this was the intention of the Board, but this clarification would eliminate any question in practice.

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?**

We believe the Board has appropriately recognized that, in many instances, it is impractical to separate long-term contracts into multiple performance obligations due to the significant over-arching contract management services and pervasive prime contracting risks related to the complex and interrelated nature of the underlying tasks. This is highlighted in the application guidance in paragraphs BC56 through BC59. However, we believe this concept should have more prominence in the proposed standard, as interpretations of “distinct profit margin” could vary widely and the guidance therein related to contract management services and risks is helpful in making appropriate interpretations in our industry. Further, we believe that this guidance should apply to all of the segmentation (if this concept survives) and performance obligation requirements to ensure 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. For example, as part of a contract that involves the highly complex detailed design and integration of mission system equipment, we may do relatively straightforward tasks that could be done by many parties, such as procure laptops to use in conjunction with the mission system. However, we would not view our procurement of the laptops as a separate performance obligation, as the contract management services and the risks are so interrelated that they cannot be separated since the utility to the customer is the overall integrated solution. More specifically, the customer is looking to us to manage its entire project and deliver a fully integrated system that works effectively, and the procurement of laptops, itself, does not have a stand-alone risk to the contractor.

Furthermore, as noted above in our response to question 1, we believe the Board should consider whether providing both segmentation and performance obligation guidance is useful.
We appreciate the Board’s concern that if a contract has a variable transaction price, an entity may allocate changes in the transaction price to all performance obligations in the contract rather than to the applicable individual piece of the contract. However, we believe this issue may be better addressed in the guidance on allocating transaction price and propose that the Board clarify that if variable consideration relates to a single performance obligation, an entity should allocate it only to the related performance obligation.

In addition to these considerations, we recommend that the Board consider the potential value of a “top-down” approach for identifying performance obligations. The Exposure Draft currently requires the identification of tasks and aggregation of those tasks into performance obligations (a “bottom-up” approach). We find this to be more confusing and complex than the current approach in ASC 605-35. A “top-down” approach focused primarily on the contract and indicating when it is appropriate to employ that approach may be more operable when implementing the standard across many varied industries and would ensure that financial reporting aligns with how companies bid, negotiate and manage their contracts. We recognize it is inherently difficult to promulgate guidance that would allow the economic substance of multitudes of existing and future revenue arrangements to be properly reported in all cases. For example, we acknowledge that the software industry believes that segmentation of the software and electronic (or computer-based) components of an off-the-shelf mobile phone provides the most decision-useful information to its investors. Conversely, we believe treating integrated long-term construction / production-type contracts as a single effort or performance obligation provides, in many cases, the most decision-useful information to our investors. As a result, we believe promulgating prescriptive combining / segmenting guidance to reflect the economic substance of arrangements is inherently difficult using a “bottom-up” approach. Balancing the desire to have a single standard for revenue recognition in varied industries and the need for individual companies and industries to report financial results consistent with how their contracts are bid, negotiated and managed, we believe the Board should consider aligning the identification of performance obligation principles with the current guidance in ASC 605-35 that allows for a “top-down” approach and provides appropriate flexibility to allow for practicality and the application of reasonable judgment to ensure financial results reflect the underlying economics of the related contracts. We believe that if given the option in this manner, companies will naturally segment contracts into their logical components in order to relay to investors and management their economic performance. We also believe that if companies disclose their policies for segmentation and apply those policies consistently, decision-useful information will result.

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?

We believe the current language in the Exposure Draft does not provide sufficient guidance with respect to when continuous transfer of control exists. We believe the Board could add indicators of contractual relationships that are evident in a continuous transfer of control model. Such indicators would not conflict with the general indicators of transfer of control in paragraph 30 and could follow paragraph 32 under the heading of Continuous Transfer of Goods or Services. These indicators could include such factors as the following:

- The contract involves an ongoing relationship over a long-term period of performance;
The customer has the ability to customize the product or service;

- 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 dedicated to the contract in question; and
- The scope of work involves specific, unique assets or services rather than the mass production of identical assets or performance of routine services.

Absent such indicators, contractors have no basis beyond the guidance in paragraph 30(d) for supporting continuous transfer of control despite the fact that there are numerous contractual circumstances not addressed by 30(d) that further support the continuous transfer model.

In addition, we believe paragraph 31 of the Exposure Draft should be modified to clarify what we believe to be the Board’s intent with respect to the indicators of transfer of control. We believe the Board intended that the paragraph 30 criteria referenced in paragraph 31 should not be considered alone and apart from the overall facts and circumstances when determining if control has been transferred. We are concerned that 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. This latter interpretation produces a formulaic “bright line” test that seems inappropriate to an otherwise principles-based and judgment-driven standard. We think paragraph 31 should be revised to more clearly state that the mere presence or absence of any one or more of the suggested indicators should not substitute for an overall evaluation of the facts and circumstances when determining if control has transferred. We also believe that paragraph 31 should clarify that none of the suggested indicators is of greater importance than the others.

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?

We agree that an entity should recognize revenue on the basis of an estimated transaction price in the appropriate circumstances. However, we believe the conditions outlined in paragraph 38 are unnecessarily restrictive with respect to these circumstances. It is not uncommon for the fee or margin component of the selling price on contracts in our industry to be variable and dependent upon factors that allow for estimation of the ultimate value to be realized on the contract. Generally, contractors would not be willing to enter into a contractual relationship to produce a good or service if they could not reasonably estimate the expected value to be received for their efforts, including a fee or earnings component. In such circumstances, estimation of the selling price expected to be realized on the contract is an essential element of the transaction.

Considering the above, we believe that the criteria in paragraph 38 are too simplistic and restrictive. We believe the language should be expanded to fit circumstances that are more common. We would suggest changes to paragraph 38 as follows.
“An entity shall recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The following are indicators of circumstances in which the seller can reasonably estimate the transaction price:

(a) the contract’s terms and conditions are such that it is clear that a key element of the contract price is variable and dependent upon conditions that may be in the customer’s or seller’s control;

(b) the contracting entity has previous experience with similar types of contracts or with the customer in similar contractual arrangements, and the contracting entity’s experience is relevant to its ability to estimate the revenue ultimately expected to be realized on the contract;

(c) the contract contains objective criteria that are useful in estimating the variable consideration under the contract.”

We also suggest changing the introductory language in paragraph 39 to state, “Other factors to consider that may reduce the relevance of an entity’s experience...” because we feel the current language is too restrictive.

Further, we do not agree with a probability-weighted approach in determining the amount of variable consideration. When estimating the transaction price for contracts with variable consideration, especially when there are binary outcomes, the use of probability-weighted amounts likely would lead to recording revenue at an amount that is not a possible outcome under the contract. The approach adds unnecessary complexity to the assessment of transaction price for a result that would not accurately reflect the transaction prices and underlying economics of the transaction or provide decision-useful information. Therefore, we support the use of management’s best estimate for the measurement of a variable transaction price. We believe that management’s best estimate is the most useful measure as it allows for the exercise of 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 averaging a range of possible, potentially arbitrary outcomes. If an entity were not able to support an estimate for variable consideration included within a contract, no revenue would be included in the amount of the transaction price to be allocated to those performance obligations where the transaction price is measurable.

Consistent with our suggestion (in the above response to question 1) that the Board consider eliminating the guidance on segmentation and provide further guidance on allocating transaction price to specific performance obligations, we propose that the Board clarify that if variable consideration relates to an individual performance obligation, an entity should allocate changes in the estimate of variable consideration only to the related performance obligation.

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?

We do not agree that a customer’s credit risk should be reflected in the estimate of the transaction price. We agree with the Board that collectability should not impact when an entity recognizes revenue and that revenue should be recognized when the customer obtains control
of the good or service as currently proposed. However, we believe a customer's credit risk should be accounted for as an adjustment to contract earnings through recording bad debt expense as an element of cost of sales. Further, we question the usefulness of recording subsequent cash receipts in excess of the estimated transaction price in income outside of revenue. In this respect, we believe both the initial accounting and subsequent adjustments related to a customer's credit risk should be reported as an adjustment to contract earnings through recording bad debt expense as an element of cost of sales.

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?

We are not opposed to the notion of adjusting the amount of promised consideration in a contract to reflect the time value of money. However, we believe this bifurcation should be limited to specific circumstances in which the contracting parties intended for a portion of the consideration to represent transaction financing. To this end, we ask the Board to consider modifying the proposed guidance to require consideration of the substance and intent of the parties in determining whether time value of money is a factor in a contract. In many contracting situations, contract payment terms are designed to protect the financial interests of the contractor (e.g., sound business practice to get an up-front advance as a security deposit), but not as a financing mechanism. We believe the standard should require clear evidence of the intent of the parties to include a financing mechanism in the contract as a requisite to the application of the time value of money principle.

7. Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the stand-alone 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?

We generally agree that an entity should allocate transaction price to all separate performance obligations in a contract in proportion to the stand-alone selling price. However, if the allocation of transaction price to the separate performance obligations of what is a profitable contract at inception yields certain performance obligations that appear to be onerous, we believe such a condition indicates that the various performance obligations are dependent on one another. As such, we believe that these performance obligations should be combined in the same manner that contracts with interdependencies are combined under paragraph 13 of the Exposure Draft, which would result in the allocation of transaction price to the single, combined performance obligation. In these instances, we believe that recording an onerous liability for a performance obligation at the inception of an overall profitable contract does not provide decision-useful information.

Alternatively, if the Board disagrees with our above suggestion, we argue that in cases where a day-one loss would be recorded for onerous performance obligations on an overall profitable contract or program, some, if not all, of those costs in excess of revenues represent an asset in the context of paragraph 57 of the Exposure Draft. As discussed further below in our combined response to questions 8 and 9, we believe that in these instances, an investment is made and an asset created related to the production of early units that will benefit production on later units. In addition, adverse changes that result in reduced profitability of any individual
performance obligation subsequent to day one would be reported via reduced profit margins on the contract or program. This impact would manifest immediately in the contractor’s financial results.

Considering the above, we recommend that the onerous performance obligation guidance in paragraphs 54 through 56 of the Exposure Draft be revised to require the onerous test be performed at the contract or program level. Additionally, we recommend that the following guidance be inserted after paragraph 56:

- If the entity bids a contract or program with a day-one loss, consider whether the costs incurred to fulfill the contract or program give rise to an asset in accordance with the guidance in paragraph 57; and

- A loss on a performance obligation shall be recognized upon satisfaction of the performance obligation first as a reduction to the liability for the related onerous contract or program and then as a period expense.

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?

See the combined response to questions 8 and 9 below.

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?

If long-term construction / production-type contracts cannot be scoped-out of the proposed standard, we reiterate our recommendation that the Board retain the existing guidance in ASC 605-35 and ASC 912 for costs associated with contracts and programs. Alternatively, we recognize and appreciate that the Board has included guidance in the proposed standard for capitalization of contract costs that are incurred in satisfying performance obligations. However, we do not believe the proposed guidance, as written, is operational or sufficient. Specifically, we believe that the proposed guidance would lead to financial results that are not representative of the duration and complexity of our contracts and the underlying contractual relationships that exist with our customers. In order to make the standard operational and to ensure that the resulting accounting appropriately reflects the underlying economics of long-term construction/production-type contracts, we recommend the Board consider the following enhancements to the guidance for contract costs.

Precontract Costs

Our contracts frequently require the contractor to incur costs for the purchase of materials, production equipment, or supplies that are expected to be used in connection with
anticipated contracts due to the substantial lead-time required in fulfilling customer obligations once a contract is executed. We believe it is appropriate to defer these costs and recognize the costs over the performance term of the contracts when recovery is probable. We recommend that paragraph 57(a) of the proposed guidance, which states that only those costs that “relate directly to a contract (or a specific contract under negotiation)” are to be capitalized as an asset, should be revised to replace “(or a specific contract under negotiation)” with “or reasonably anticipated contracts (i.e., those that are probable).”

*Deferred Production Costs*

In our industry, management's commitment to moving forward with a production program is based on long-term profitability and cash flow analyses, recognizing that production costs in the earlier stages of a program lifecycle will be substantially higher than production costs in the later stages of a program lifecycle. It is these very assumptions on which our entire pricing model is based. As such, we believe that the higher costs incurred in early production stages represent investments in the program that relate not only to the discharge of obligations in those early stages, but to the entire production run or life of the program (i.e., not just the first unit produced). Examples of program investments include non-recurring engineering costs, learning curve efficiencies, product costs currently allocable to multiple units under a production lot or program accounting methodology and set-up costs for the delivery of services. We currently capitalize these costs because they meet the definition of an asset under FASB Concept Statement No. 6- “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” The guidance proposed in the Exposure Draft essentially narrows the definition of an asset in the context of contracts with customers. Program investments generally meet the three essential characteristics of an asset as follows:

- They embody a reasonably expected future benefit that involves a capacity to contribute to future net cash inflows.
  - Program investments generate know-how and intellectual property that will be used in future production and result in overall positive cash flows for the entity.
  - If it were not for the first unit produced (and the learning that comes with that effort), the second unit would essentially represent the "first unit" at the same higher cost.

- An entity can obtain the benefit and control others’ access to it.
  - We control access to the know-how and intellectual property generated from the program investments.

- The transaction giving rise to our right to and control of the benefit has occurred.
  - We have incurred the program investment costs that are capitalized.

Without the ability to capitalize program investments, the proposed model appears to require recognition of losses on delivery of the first units, where fulfillment costs could be significantly higher than the sales price, and higher profits on delivery of later units, where fulfillment costs are significantly lower than the sales price. The resulting variable profit recognition would be inconsistent with the economics of the transactions with our customers, and would not provide our investors with decision-useful information concerning results of
operations. We believe that the guidance on program investments that may be capitalized and attributed to future performance obligations should be expanded to reflect the realities of investment decision-making, contract bidding and negotiating, and program performance management in our industry. To this end, we recommend that the parenthetical expression "that is, the costs relate to future performance" be eliminated from paragraph 57(b).

We believe that these proposed recommendations would allow enough flexibility in the guidance to allow us to continue to capitalize program investments whose recovery we can support, ensuring that the financial results reflect the underlying economics of transactions with customers and provide decision-useful information to investors. If the recommendations proposed above still would not qualify program investments for capitalization, then we recommend:

- Adding a scope-out to paragraph 57 for existing guidance on program accounting in ASC 912-20, paragraphs 25-5A and 25-6; and,

- Adding a scope-out to paragraph 57 for existing average cost guidance for production lots in ASC 605-35 paragraph 25-9.

Support for Cost Deferrals

While we do not object to any of the specified criteria in paragraph 58 for recognizing costs as an asset, we do not believe that the proposed criteria are complete. International Accounting Standards 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 pivotal in aligning the accounting treatment of long-term construction / production-type transactions between U.S. Generally Accepted Accounting Principles ("U.S. GAAP") and International Financial Reporting Standards ("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 U.S. GAAP versus IFRS, due to the ability of a company reporting under IFRS to capitalize and spread costs that would otherwise be expensed as incurred under U.S. GAAP.

Paragraph 57(b), 59(b) and 60 make a distinction between satisfaction of past and future performance obligations. As written, we do not believe that this distinction is operable in our industry. As previously discussed, costs are incurred in the early stages of a program lifecycle that benefit production in the later stages of a program lifecycle. These costs, referred to as program investments, represent the genesis of know-how and intellectual property that will be used in future production and result in overall positive cash flows over the course of the program. As such, we recommend that the Board 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.

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?

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?

12. 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?

We offer our responses to the questions on disclosure (Exposure Draft paragraphs 69-83) collectively, as follows.

As the proposed model will apply across all industries, we do not believe prescriptive disclosures are beneficial given the substantial differences across business models. We suggest requiring disclosure using a principles-based approach, as opposed to prescriptive disclosures that may not be meaningful to financial statement users. A principles-based approach would allow preparers to provide quantitative information they deem necessary to support the qualitative descriptions of their contract activities. In this manner, different industries could provide relevant information to their respective financial statement user groups. We believe the disclosure principle in the proposed standard needs to weigh three key elements: 1) the benefits investors will receive versus the cost to provide the disclosures; 2) the level of disaggregation of quantitative disclosure information and principles to determine that level; and 3) when non-financial or forecast data should be included in the required disclosures and the related impact on audit firms and the safe harbor protections afforded under the PSLRA and related SEC regulations.

Given the magnitude of the number of contracts performed by companies in our industry, the additional quantitative disclosures and tabular reconciliation of balance sheet amounts described in the Exposure Draft would not provide decision-useful information to financial statement users in our view. We believe that quantitative disclosures should be used to supplement the qualitative disclosures about an entity's contracting activities that currently provide useful information to financial statement users about the performance on particular contracts. Further, the qualitative disclosures should be limited to sales by contract type or by line of business rather than at the detailed level of a particular good or product. We believe any further disclosures of contract assets and liabilities, particularly the tabular reconciliations, should be deferred and considered separately with the financial statement presentation project.
We believe the requirement to disclose forecasted financial information, such as the breakdown of backlog by expected year of performance, significantly expands the scope of the financial statements and is inappropriate in an accounting standard that is otherwise devoted to the reporting of historical financial results. This disclosure would result in the inclusion in the audited footnotes of material, non-public information based on projections. This level of information goes beyond what is currently provided to shareholders and analysts in the typical earnings guidance and would disclose competitively sensitive information. Additionally, auditors would be required to audit long-range planning information that is subject to many changes and variability. Lastly, inclusion in the footnotes would forego the safe harbor protections regarding forward-looking statements afforded under the PSLRA and related SEC regulations. If the Board views this information as necessary, we would suggest requiring it be disclosed in a qualitative discussion.

Finally, we believe the additional cost of building the necessary information technology infrastructure to accommodate these proposed disclosure requirements would outweigh the benefits. We believe the benefits, if any, will likely be lost in the sheer volume and length that these disclosures are likely to require, such that financial statement users are unlikely to see the “forest from the trees.” Further, the additional disclosures will threaten the ability of companies in our industry to timely meet the filing deadlines of public registrants. We also feel 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. A compromise would be to provide certain limited additional disclosures about the amount of sales by contract type annually on a comparative basis similar to current disclosures in Management’s Discussion and Analysis of Results of Operations and Financial Condition in companies’ quarterly and annual filings with the SEC.

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.*

We do not agree that the proposed guidance should be applied retrospectively due to the impracticality of such restatement. ASC 250 details the following conditions that indicate the impracticality of retrospective application of changes in accounting principle:

- An entity is unable to apply the requirement after making every reasonable effort to do so;

- An entity is required to make assumptions about management’s intent in a prior period that cannot be substantiated; and/or

- An entity is required to make estimates of amounts for which it is impossible to distinguish objective information about those estimates at the time they were made.

We believe that each of these indicative conditions is relevant to the proposed Exposure Draft guidance in some regard for the following reasons:
• Our contract base is composed of thousands of contracts that often span for a period of several years. (Likewise, revenues for essentially all industries are based on thousands of transactions with customers for any given year.) It would be extremely complex and time-consuming to recast these contracts to their inception, requiring the revision of quarterly estimates of profitability on a contract-by-contract basis over a multi-year period. To track this population of contracts across a wide range of systems and manual records, including truing up the historical revenue recognition on these contracts for activity that predates the beginning of the retrospective period, would impose significant expense and require an excessive time commitment by our contract management and finance personnel.

• Entities make assumptions and estimates at multiple points throughout a contract’s life and evaluate these assumptions and estimates in conjunction with other contemporaneous information relating to the contract’s performance. Retrospective adoption presupposes that an entity can re-create the contemporaneous environment in which it made prior judgments allowing for a fully informed decision under the proposed guidance for each past contract decision point. Given the number of decisions that entities make across thousands of contracts, we believe that it is impracticable to apply the standard retrospectively and expect it to produce information that is decision-useful to investors.

As an alternative, we suggest that the proposed guidance be applied prospectively for contracts with customers entered into after the effective date of the standard. Many other major revenue recognition standards have been applied on a prospective basis, including most recently Accounting Standards Update (ASU) No. 2009-13, Multiple-Deliverable Revenue Arrangements, a consensus of the FASB Emerging Issues Task Force, and Update No. 2009-14, Software (Topic 985): Certain Revenue Arrangements that Include Software Elements. Given the Board’s intent that the proposed standard not have a significant impact to any companies’ revenue recognition practices, there should be no material impact to trend information about revenue or an impairment of the comparability of past and future accounting periods. However, the retroactive restatement approach would require companies to engage in the burdensome exercise described above.

To address the Board’s concern regarding the preservation of revenue and trend information, we suggest that entities be required to disclose information that enables users of the financial statements to understand the effect of the change in accounting principle in the spirit of ASC 250. Such disclosures may include some or all of the following items:

• The method of applying the change and any material impact on the current period of applying the change to new contracts;

• A qualitative and/or quantitative discussion of the entity’s major products and services for which revenue recognition under the proposed guidance will be materially different;

• The portion of the entity’s revenues and/or earnings in the period that have transitioned to be accounted for under the proposed guidance; and/or

• An estimate of the run-out of the company’s backlog accounted for under the former standards.
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?

We believe the implementation guidance is overly simplistic, that is, we find the examples overwhelmingly skewed toward the outcome at each end of the spectrum per the fact patterns presented. As the examples are intended to make the proposed guidance operational, we are concerned that accounting firms may interpret the example guidance to mean companies must have similarly overwhelming fact patterns to substantiate the positions they take, rather than employing judgment in the context of the proposed standard to make determinations according to more realistic and common “gray” fact patterns. We recommend that the Board consider adding more complex, realistic examples that clarify the Board’s intentions in applying the principles set forth in the proposed standard.

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?

We agree that certain warranties do not give rise to performance obligations while others do. We believe additional clarifications may be required to make the distinction workable, as we have concerns about the operability of the concept of “latent defects.” Where a warranty does not represent a separate performance obligation, we believe revenue should not be allocated or deferred with respect to such warranties and, instead, such “standard warranties” should be accounted for as accrued cost in accordance with current industry practice. We believe accruing the cost of providing a warranty is more representative of the underlying economics than allocating revenue and margin to standard warranties. Generally, warranties entitle customers to repairs or replacement of defective deliverables and do not entitle them to refunds. As such, the provision of a standard warranty is always a cost of performance as opposed to a revenue-generating activity. We believe that it may be very difficult in situations where a company offers a standard warranty to determine whether a portion of the warranty is intended to cover pre-delivery defects as well as post-delivery issues and, therefore, we believe that additional guidance should be provided to ensure this is not an unintended outcome. We believe that separately priced extended warranty coverage, which may be purchased at the discretion of the customer, should be accounted for as a separate performance obligation, with revenue recognized as the related services are delivered.
We also ask that the Board consider including language applicable to long-term service type contracts. The industry currently accounts for these contracts under FTB 90-1: Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts. As the Exposure Draft is written, we believe these types of contracts would fall under the “Managed Services” concept due to the transfer of risk from operator to contractor that is inherent in the contract, but it is unclear as to whether this is the Board’s intent. In our industry, companies may enter into agreements with customers to perform maintenance services on their aircraft; for example, an agreement under which an airline pays the service provider a set fee per flight hour in exchange for a part, such as the auxiliary power unit (“APU”) on a fleet of planes to be maintained whenever and wherever the customer may need service. This type of contract presents the question of whether segmenting the contract into individual units of accounting is appropriate or whether these contracts can be accounted for as one unit under the Managed Services concept.

In addition, consider contracts to deliver scheduled and unscheduled maintenance services. Maintenance Service Contracts are accounted for in accordance with current literature as one unit of accounting. As prescribed, total contract costs and total contract revenues are estimated over the life of the contract to arrive at an overall contract margin. This margin is then applied to all services and costs incurred over the given contract through a markup percentage applied to costs. If segmented into individual units of accounting, those segments could be interpreted in multiple ways. For example, as simply a service contract in which we account for each repair as performed, or as though there are multiple groups of performance obligations in addition to the actual services. At least two groups of performance obligations could be identified as follows:

The first group of performance obligations would be the actual services to be performed. This group would then potentially have multiple obligations within it – a forecasted number of scheduled events and an estimate of unscheduled events. To better define, an event is viewed as each time an APU comes in for service. During any “event,” one or multiple services could be performed on an APU. Over the life of a contract (typically 10 years in length), imagine an APU comes in for service once every two years and is part of 100 APUs under the contract. Even in this conservative example for one contract, there are 500 performance obligations, all of which would need to be accounted for separately. Each obligation could, if the Exposure Draft’s position is not clarified, have its own revenue, which would be a sub-set of the revenue for the entire performance obligation group.

The second group of performance obligations relates to the convenience and peace of mind that the operator is provided i.e., the management of all elements of service (what type of service is provided, when, at which location, etc.). Again, if the if the Exposure Draft’s position is not clarified, this group of obligations could be recognized separately from the first. The question arises as to how that revenue would be recognized, which presumably would be over the contract period, based on a calendar year or flight hours. If this second group of obligations were to be recognized in revenue on a flight hour basis, then we would potentially allocate one amount per flight hour to this group and have the balance set aside until the work is performed (the sub-set of the first group).

As one can see, this type of accounting would cause recognition of the same amount of revenue, per performance obligation, over the life of the contract, causing large swings (sometimes losses) in margin. This type of accounting is exactly what FTB 90-1 was intended to correct and further prevent, as it is misleading to our financial statement readers since it
distorts the results of performance over the contract life. The cost inputs to these contracts are determinable over the contract period but not so determinable that they can be broken into performance obligations. We recommend that the guidance on warranties be modified to permit companies to account for these contracts on a modified cost basis (under FTB 90-1), as we do now. We believe this could be accomplished through simply adding language into the Management Services guidance permitting long-term service contracts with uneven but overall predictable, cost patterns to be considered under this concept.