

Financial Reporting Center – Revenue Recognition

Working Draft: Aerospace and Defense Revenue Recognition Implementation Issue



Issue #1-6: Identifying the Unit of Account in Design, Development, and Production Contracts

Expected Overall Level of Impact to Industry Accounting: High

Wording to be Included in the Revenue Recognition Guide:

Identifying the Performance Obligations in the Contract

1. FASB ASC 606-10-25-14 through 25-22 discuss how to determine whether promised goods and services in the contract represent separate performance obligations.
2. FASB ASC 606-10-25-16A and BC12 of FASB ASU 2016-10, Revenue from Contracts with Customers (Topic 606) – Identifying Performance Obligations and Licensing, first establish that immaterial items are not required to be assessed as promised goods or services for purposes of identifying performance obligations. A contractor should consider the relative significance or importance of a particular promised good or service at the contract level rather than at the financial statement level, considering both the quantitative and the qualitative nature of the promised good or service in the contract. Although this assessment is expected to be straightforward in many cases, applying this notion will often require judgment. FASB ASC 606-10-25-16B also clarifies that this approach to materiality does not apply to customer options and related material rights, where specific guidance in 606-10-55-41 through 55-45 applies. When goods or services are assessed as immaterial in the context of the contract and are not treated as performance obligations, any transaction price charged for those items will be allocated to the performance obligations in the contract and recognized when those performance obligations are satisfied. FASB ASC 606-10-25-16A indicates that the costs of these immaterial goods and services should be accrued if the related revenue is recognized in advance of the immaterial goods or services being transferred to the customer.
3. FASB ASC 606-10-25-14 establishes that a contractor should assess goods or services promised in a contract (unless immaterial as seen above) and identify as performance obligations each promise to transfer to the customer either:
 - a. A good or service (or bundle of goods or services) that is distinct; or,
 - b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
4. FASB ASC 606-10-25-15 explains that a series of distinct goods or services has the same pattern of transfer to the customer if both the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time; and
 - b. In accordance with ASC 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
5. Determining whether goods and services are distinct is a matter of judgment. BC29 of FASB ASU 2016-10 clarifies that a contractor should evaluate whether the multiple promised goods or services in the contract are outputs or, instead, are inputs to a combined item (or items). The inputs to a combined item (or items) concept might be further explained, in many cases, as those in which an entity's promise to transfer the promised goods or services results in a combined item (or items) that is greater than (or substantively different from) the sum of those promised (component) goods and services. A combined output may include more than one phase, element, or unit.
6. While FASB ASC 606-10-25-19(a) effectively looks to the economic substance of each good or service to determine whether a customer can benefit from that good or service either on its own or with readily-available resources or those available to the customer in the marketplace, ASC 606-10-25-19(b) requires the contractor to evaluate whether the promised good or service is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract) and ASC 606-10-25-21 provides a non-exclusive list for the contractor to consider. A contractor's evaluation of the indicators may vary depending on the specific circumstances of the contract, and one contractor's evaluation may not coincide with another's.
7. In many aerospace and defense contracts, the finished deliverable consists of a number of subcomponents that normally provide benefit to the customer on their own or together with other readily available resources. Therefore, the contractor's evaluation regarding whether a promised good or service is distinct will likely depend more on meeting the criteria in FASB ASC 606-10-25-19(b).
8. FASB ASC 606-10-25-21 includes certain factors for consideration in determining whether a contractor's promise to transfer a good or service to a customer is separately identifiable; however, it does not limit a contractor's consideration only to those factors identified. As a result, an entity's evaluation of the indicators in FASB ASC 606-10-25-21 will be largely driven by the nature of the transaction and the specific facts and circumstances of the contract.
9. For instance, BC30 of FASB ASU 2016-10 acknowledges that the notion of 'separable risks' can influence the separately identifiable concept analysis. Therefore, understanding whether the risk that an entity assumes to fulfill its obligation to transfer one of those promised goods or services to the customer is a risk that is inseparable from the risk relating to the transfer of the other promised goods or services, may help the analysis under FASB ASC 606-10-25-21.
10. As explained in BC32 of FASB ASU 2016-10, the contractor should evaluate whether two or more promised goods or services (for example, a delivered item and an undelivered item) each significantly affect the other (and, therefore, are highly interdependent or highly interrelated) in the contract. The contractor should not merely evaluate whether one item, by its nature, depends on the other (for example, an undelivered item that would never be obtained by a customer absent the presence of the delivered item in the contract or the customer having obtained that item in a different contract).
11. According to BC33 of FASB ASU 2016-10, a contractor should also consider the utility of the promised goods or services (that is, the ability of each good or service to provide benefit or value). This is because a contractor may be able to fulfill its promise to transfer each good or service in a contract independently of the other, but each good or service may significantly affect the other's utility to the customer. The "capable of being distinct" criterion also considers the utility of the promised good or service, but merely establishes the baseline level of economic substance a good or service must have to be "capable of being distinct." Therefore, utility also is relevant in evaluating whether two or more promises in a contract are separately identifiable because even if two or more goods or services are capable of being distinct because the customer can derive some economic benefit from each one, the customer's ability to derive its intended benefit from the contract may depend on the entity transferring each of those goods or services.
12. Another important judgment in interpreting FASB ASC 606-10-25-21(a) is whether the integration service is significant. BC 107 of FASB ASU 2014-09 explains that the risk of transferring individual goods or services is inseparable from an integration service because a substantial part of the entity's promise to a customer is to ensure the individual goods or services are incorporated into the combined output. BC 107 continues to explain that this factor may be relevant in many construction contracts in which the contractor provides an integration (or

contract management) service to manage and coordinate the various construction tasks and to assume the risks associated with the integration of those tasks.

13. An integration service may be clearly evident when combining a number of subcomponents into a single deliverable (e.g., a single ship). However, many aerospace and defense contracts are for the provision of multiple units of the same (or similar) end product (such as multiple ships, vehicles, etc.). In these arrangements, additional judgment will be required when evaluating whether there is a substantial integration service across the multiple units and not just within each individual unit.
14. FASB ASC 606-10-25-21(b) states that two or more promises to transfer goods or services to a customer are not separately identifiable when “one or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised by the contract.” BC108 of FASB ASU 2014-09 indicates that the factor described in ASC606-10-25-21(a) could apply to industries other than the construction industry and provided an example of a software development contract with significant integration services. As a result, the Boards clarified the factor discussed in FASB ASC 606-10-25-21(b). BC 108 of FASB ASU 2014-09 further explains that it was not intended for this factor to be applied too broadly to software integration services for which the risk that the entity assumes integrating the promised goods or services is negligible.
15. Some aerospace and defense companies enter into arrangements for IT-related goods and services and consistent with BC107 and BC108 of ASU 2014-09, this factor should be considered with respect to such contracts. This factor might also be applicable to other circumstances where a good or service is being modified or customized. For example, an aerospace and defense company might promise to deliver to a customer a standard vehicle that has been substantially modified for the customer’s purposes (e.g., replacing quarter panels with armor, modifying the engine, frame and suspension to accommodate additional weight, installing bulletproof glass). In this circumstance, FinREC believes that these services are significantly modifying or customizing the vehicle and those services should be combined with the vehicle into a single distinct performance obligation. If the contract was to deliver multiple standard vehicles with customization services, the entity would need to consider the factors in FASB ASC 606-10-25-21 in assessing if the promise to transfer each separate vehicle is distinct within the context of the contract.
16. The factor in FASB ASC606-10-25-21(c) explains that two or more promises to transfer goods or services to a customer are not separately identifiable if the goods and services are highly interdependent or highly interrelated. BC111 of FASB ASU 2014-09 indicates that, in some cases, it might be unclear whether the entity is providing an integration service or whether the goods or services are significantly modified or customized.
17. Example 10 – Goods and Services are Not Distinct, Case B:Significant Integration Service, in FASB ASC 606-10-55-140A through 55-140C, provides an example to illustrate a circumstance where the manufacturing of multiple units of a highly complex, specialized device is considered one performance obligation because the activities required to produce those units are highly interdependent and highly interrelated.
18. Consistent with Example 10, Case B of FASB ASC 606-10-55-140A through 55-140C, FinREC believes an entity should consider the following factors that indicate that multiple units of a product in a production only arrangement are not separately identifiable in accordance with FASB ASC 606-10-25-19(b) and therefore not distinct:
 - The product specifications are complex and customized to the customer’s needs
 - A manufacturing process specific to this contract is established in order to produce the contracted units
 - The entity is responsible for the overall management of the contract, including performance and integration of various activities including procurement of materials; identifying and managing subcontractors; and performing manufacturing, assembly, and testing.
19. FinREC believes an entity should consider the following factors that indicate that the promised goods and services in a design, development, and production contract are not separately identifiable in accordance with FASB ASC 606-10-25-19(b) and therefore not distinct:
 - During the bidding process, the customer did not seek separate bids on the design and production phases
 - The contract involves design and production services for a new or experimental product
 - The specifications for the product include unproven functionality
 - The contract involves the production of prototypes or significant testing of initial units produced for the purpose of refining product specifications or designs
 - The design of the product will likely require revision during production based on the testing of initial units produced
 - It is likely that initial units produced will require rework to comply with final specifications

20. If after having considered the factors in FASB ASC 606-10-25-21 a contractor has determined that promised goods or services are distinct, the contractor would then consider whether those distinct goods or services represent a series that are treated as a single performance obligation. As part of this analysis, the contractor would consider whether those distinct goods or services are substantially the same and have the same pattern of transfer to the customer as required by FASB ASC 606-10-25-14(b). FASB ASC 606-10-25-15 states that a series of distinct goods and services has the same pattern of transfer to the customer if both of the following criteria are met: a) each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation transferred over time, and b) in accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
21. The following examples are meant to be illustrative, and the actual determination of the performance obligation(s) in the contract should be based on the facts and circumstances of an entity's specific situation.

Example 1: Illustration of FASB ASC 606-10-25-21(a)

22. Aerospace and Defense Corp. (A&D) has contracted with the U.S. Navy to finalize design, develop and construct a warship. The U.S. Navy has specified various aspects of the warship, including the speed at which it must be able to travel, and that it must utilize nuclear power. No warship of this nature exists in the world today.
23. Nearly all of the component goods and services that will be assembled into the new warship either provide benefit to customers on their own or with other readily available resources.
24. The component goods, materials, and services to this contract (e.g., steel plates, computer systems, elevators, welding services, nuclear power generators) are not separable, and therefore not distinct, in this contract because A&D is providing a significant integration service of utilizing the various individual materials and services (and subcontractors under its direction) as inputs to deliver the combined item for which the customer has contracted (i.e., the warship).
25. As a result, A&D concludes that this contract contains only one performance obligation - the warship.

Example 2: Illustration of ASC 606-10-25-21(c) (Consistent with Example 10 – Goods and Services are Not Distinct, Case B: Significant Integration Service, in FASB ASC 606-10-55-140A through 55-140C)

26. Aerospace and Defense Corp. (A&D) has contracted with the U.S. Army to deliver multiple units of a complex and specialized armored vehicle. The U.S. Army has specified various aspects of the vehicle, including speed, weight, weaponry, and other specifications. The specifications are unique to the customer based on a specified design that is owned by the customer and was developed under a separate contract. A&D has previously produced an initial production lot of these vehicles under a separate contract and A&D has entered into a new contract for the production of multiple units. A&D is responsible for the overall management of the contract, which requires the performance and integration of various activities including procurement of materials; identifying and managing subcontractors; and performing manufacturing, assembly, and testing.
27. A&D assesses the promises in the contract and determines that each of the promised vehicles is capable of being distinct in accordance with FASB ASC 606-10-25-19(a) because the customer can benefit from each vehicle on its own. This is because each vehicle can function independently of the other vehicles.
28. A&D then assesses whether the vehicles are distinct within the context of the contract in accordance with FASB ASC 606-10-25-19(b). A&D observes that the nature of its promise is to establish and provide a service of producing the full complement of vehicles for which the U.S. Army has contracted in accordance with the customer's specifications. A&D considers that it is responsible for overall management of the contract and for providing a significant service of integrating various goods and services (the inputs) into its overall service and the resulting vehicles (the combined output) and, therefore, the vehicles and the various promised goods and services inherent in producing those vehicles are not separately identifiable in accordance with paragraphs 19(b) – 21 of FASB ASC 606-10-25. In this case, the nature of A&D's performance and, in particular, the significant integration service of the various activities mean that a change in one of A&D's activities to produce the vehicles has a significant effect on the other activities required to produce the highly complex specialized vehicles such that A&D's activities are highly interdependent and highly interrelated. Because the criterion in FASB ASC 606-10-25-19(b) is not met, the goods and services that will be provided by A&D are not separately identifiable, and, therefore, are not distinct.

29. As a result, A&D accounts for all of the goods and services promised in the contract as a single performance obligation.

Example 2A

30. In addition to the delivery of the armored vehicles described in Example 2, the contract also includes maintenance of the armored vehicles after delivery to the customer for a period of 3 years. A&D determines that the maintenance component is material in the context of the contract. The maintenance promise does not significantly modify or customize the production of the specialized vehicles and the production is not highly dependent upon the maintenance activities. A&D will satisfy the maintenance without using shared material, subcontractor, manufacturing, assembly or testing components from those used in the production of the vehicles, and the maintenance activities will be performed after the vehicles are delivered. In this case, a change in one of A&D's activities under either of these promises would not have a significant effect on the other. As such, the two promises are not highly interdependent or highly interrelated. Because the criterion in FASB ASC 606-10-25-19(b) is met, A&D's promise to provide maintenance on the vehicles is separately identifiable, and, therefore, distinct from production of the vehicles. As a result, A&D would account for the delivery of the vehicles as a single performance obligation separate from the maintenance.

31. A&D would then evaluate the maintenance activities to determine whether they consist of distinct goods or services. If the maintenance activities consist of only one distinct good or service, for example because under FASB ASC 606-10-25-21(c) A&D concludes that it provides a significant integration service between the different maintenance activities, then the maintenance activities would be treated as a single performance obligation. If A&D concludes that there are more than one distinct goods or services within the maintenance activities, for example because none of the criteria in FASB 606-10-25-21 (a) through (c) are met, A&D would then consider FASB ASC 606-10-25-14(b) and 606-10-25-15 to determine whether those distinct goods or services represent a series that are treated as a single performance obligation. As discussed at the July 2015 TRG meeting, in making this assessment, A&D would consider whether the nature of its promise for the maintenance service is a specified quantity of maintenance service or the act of standing ready to perform the maintenance service. If the nature of the promise is the delivery of a specified quantity of a service, then the evaluation should consider whether each service is distinct and substantially the same. If the nature of A&D's promise is the act of standing ready or providing a single service for a period of time (that is, because there is an unspecified quantity to be delivered), the evaluation would likely focus on whether each time increment, rather than the underlying activities, are distinct and substantially the same.

Example 2B

32. Subcontractor Y has a long term arrangement to exclusively produce for A&D the engines used on the armored vehicles described in Example 2. The engines are procured through multiple individual purchase orders which may include the volume for an entire year at a time. Each of Y's purchase orders is a separate contract with its customer.

33. In contrast to Example 2 in paragraphs 26 through 29, in this example the engines are specific to the vehicle but not highly specialized, and Subcontractor Y does not manage other subcontractors. Subcontractor Y produces engines for other specialized vehicles that have many similar characteristics to the engines being produced for A&D. While the engines required investment in non-recurring engineering, such investment was not considered significant. Y is responsible for the management of the engines contract, which requires some degree of integration across engines (for instance, Y may have to integrate certain upgrades or changes); however, this type of integration is not seen as significant in the context of the contract, which is seen primarily as the production of a quantity of known equipment. While the engines may be produced on a dedicated manufacturing line, the manufacturing process itself is similar to how Y produces unrelated engines for unrelated products for different customers. As such, the manufacturing process is not so specific as to have no transferable use on other products.

34. Because Y is in the business of producing specialized engines and typically contracts with its customers for limited incremental volumes, Y does not view a single engine as being significantly interrelated or dependent on the other engines delivered in ways that are significant. That is, Y's contracts with A&D are not contemplative of a single solution, therefore the individual engines are viewed as being distinct in the context of the contract. Since the engines are also "capable of being distinct," Y concludes that the engines are individually distinct.

35. As the engines have been determined to be individually distinct, Y would then consider FASB ASC 606-10-25-14(b) and 606-10-25-15 to determine whether those distinct engines represent a series that are treated as a single performance obligation. As part of this analysis, Y would consider whether those engines are substantially the same and have the same pattern of transfer to A&D (i.e. does each engine meet the criteria to be a performance

obligation satisfied over time and would the same method be used to measure Y's progress toward complete satisfaction of the performance obligation to transfer each distinct engine in the series).

Example 3: Illustration of ASC 606-10-25-21(c)

36. A&D Corp. entered into a contract with the U.S. Air Force on January 1, 20X0 to design and build a next generation unmanned aerial vehicle (UAV). The performance and system requirements being requested of A&D are new and advanced and will require significant research and development (R&D), a new design for the UAV, as well as the creation of a special production process for these new machines.
37. The initial contract calls for A&D to produce fifteen of the UAVs for testing and use in limited real-life scenarios. A&D expects that it will take approximately three years to design and develop the first UAV, but that the remaining fourteen initial order UAVs will be delivered over a period of two years after completion of the prototype unit. At the time of delivery of the first UAV, the remaining fourteen UAV's will be in various stages of production. Any changes in design that are made during the three years of designing and developing the first UAV will also be required to be made to the remaining fourteen in process UAV units.
38. While the customer can benefit from each UAV independently of the others (each UAV will fly and perform reconnaissance and other functions independent of the other fourteen units), A&D has determined that the design and production services and the fifteen UAVs are a single performance obligation because they are not distinct in the context of the contract. In reaching this determination, A&D observed that the contract involved a new and experimental design, the production of prototypes, significant testing and redesign efforts, and the potential for rework of all 15 units to comply with final specifications. As a result the design and production services and UAVs are considered highly interdependent and highly interrelated to each other.

Comments should be received by May 1, 2017, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.