Working Draft:

Aerospace and Defense Revenue Recognition Implementation Issue

Issue #1-8: Contract modifications including unpriced change orders, claims and options

Expected Overall Level of Impact to Industry Accounting:

Moderate

Wording to be Included in the Revenue Recognition Guide:

Contract modifications including unpriced change orders, claims

1. It is common in the aerospace and defense industry for customers to change contract specifications and requirements, particularly in development contracts. This is because development contracts typically span over multiple years and include the integration of multiple goods and services. These contracts typically authorize the contractor to proceed with the modifications to the scope of the contract even though the price has not been agreed upon between the parties. Judgment will often be needed to determine whether changes to existing rights and obligations should have been accounted for as part of the original arrangement (that is, should have been anticipated due to the entity's business practices) or accounted for as a contract modification.

2. A contract modification could change the scope of the contract, the price of the contract, or both the scope and price of the contract. As noted in FASB ASC 606-10-25-10, a contract modification exists when the parties to a contract approve a modification that either creates new or changes the existing enforceable rights and obligations. A contract modification could be approved in writing, oral, or implied by customary business practices.

3. Aerospace and defense industry service and maintenance contracts may contemplate and allow for future changes to technical plans to comply with FAA service bulletins or to implement an improved repair process or procedure. The risk and/or reward of changes to the technical plan are key characteristics of the performance obligation underlying the nature of these contracts when the entity is standing ready to provide an integrated maintenance service. Although changes to the technical plan may require customer approval (required by FAA as the operator/customer must "own" the technical plan) and take the form of a contract amendment or modification, judgment will be necessary to determine whether the changes create new or change the existing enforceable rights and obligations of the contract. Revenue related to a modification is not recognized until new enforceable rights and obligations exist or existing enforceable rights and obligations are changed.

4. In some cases, the entity may make a claim (described in paragraph BC81 of ASU 2014-09 as "specific modifications in which the changes in scope and price are unapproved or in dispute") against a customer for

additional amounts that the entity seeks to collect in excess of the agreed contract price. Claims are normally made as a result of customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved concerning both scope and price, or other causes of unanticipated additional costs. Claims can also give rise to a contract modification. However, as stated in FASB ASC 606-10-25-11, "in determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence".

5. Enforceability of the rights and obligations in a contract is a matter of law. The practices and processes for establishing contracts with customers vary across legal jurisdictions, industries and entities. In addition, they may vary within an entity. An entity should include consideration of those practices and processes in determining whether and when an agreement with a customer creates enforceable rights and obligations.

6. Determination of whether a contract claim is an enforceable right will require judgment. Management should consider whether the contract or other evidence provides a legal basis for the claim.

7. Paragraph BC39 of ASU 2014-09 states that "the Boards clarified that their intention is not to preclude revenue recognition for unpriced change orders if the scope of the work has been approved and the entity expects that the price will be approved. The Boards noted that, in those cases, the entity would consider the guidance on contract modifications." BC81 of ASU 2014-09 also addresses unpriced change orders and claims and notes that the Boards concluded it was unnecessary to provide specific guidance on the accounting for these types of modifications because FASB ASC Topic 606 includes relevant guidance in FASB ASC 606-10-25-10 through 25-13.

8. Contract modifications are accounted for as either a separate contract or as part of the existing contract depending on the nature of the modification.

9. FASB ASC 606-10-25-12 requires that a contract modification be accounted for as a separate contract if both of the following conditions are present:
   a. The scope of the contract increases because of the addition of promised goods or services that are distinct; and
   b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling price of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

10. FASB ASC 606-10-25-13 explains that if a contract modification does not meet both of the criteria in ASC 606-10-25-12 to be accounted for as a separate contract, the remaining promised goods or services should be accounted for as an adjustment to the existing contract, either prospectively or through a cumulative catch-up adjustment depending on the specifics of the contract modification.

11. As explained in FASB ASC 606-10-25-13(a), an entity should account for a contract modification as if it were termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligation (or to the remaining distinct goods or services in a single performance obligation identified in accordance with 606-10-25-14(b)) is the sum of:
    a. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
    b. The consideration promised as part of the contract modification.

12. As explained in FASB ASC 606-10-25-13(b), an entity should account for a contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied when the contract is modified. The effect of the contract modification on the transaction price, would be recognized as an adjustment to revenue at the date of the contract modification (that adjustment to revenue is made on a cumulative catch-up basis).

13. When a change order is combined with the original contract and the remaining goods or services are part of a single performance obligation that is partially satisfied, the contractor should consider the guidance in FASB ASC 606-10-25-12 and 25-13 and update the transaction price and measure of progress towards completion of the contract accordingly. As noted in FASB ASC 606-10-25-13 (B) in this situation the contractor will recognize the effect of the contract modification as revenue (or as a reduction of revenue) at the date of the contract modification on a cumulative catch-up basis.

14. When measuring the change in transaction price as a result of an approved contract modification when the price of the modification has not been agreed upon between the parties, an entity should follow the guidance in FASB ASC 606-10-32-5 through 32-9 on estimating variable consideration and FASB ASC 606-10-32-11 through 32-13 on constraining estimates of variable consideration. The entity should incorporate all relevant information and evidence in evaluating its best estimate of variable consideration and whether it is probable that a significant reversal of that amount will not occur when the amount is ultimately finalized. Some of the factors to consider in evaluating this amount include documentation for change order costs that are identifiable and reasonable, and the entity's favorable experience in negotiating change orders, especially as it relates to the specific type of contract and change order being evaluated. FinREC believes that this constrained estimate of the change in transaction price as a result of the contract modification should be utilized in the assessment of the nature of the modification following FASB ASC 606-10-25-12 and 25-13, as well as in any adjustment to revenue arising from the application of this guidance (for example, a cumulative adjustment to revenue as described in FASB ASC 606-10-25-13(b)).

15. If the final change in transaction price ultimately agreed with the customer for the unpriced change order or claim differs from the estimate determined above, that change should be accounted for in accordance with FASB ASC 606-10-32-42 through 32-45. FinREC believes that an entity should not subsequently revisit or adjust the original conclusion as to the type of modification the change order represented (e.g. whether the change in transaction price reflected the standalone selling price of additional distinct goods or services), unless there are indications that the original assessment reflected a misapplication of the facts as they existed at the time.

Options including unexercised options in a loss position

Determining if an option conveys a material right

16. Aerospace and defense contracts often contain options that give customers the right to purchase additional goods or services. Contracts with the United States Government ("USG") may contain options for additional units or renewals. FASB ASC 606-55-42 states:

> If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer is in effect paying in advance for future goods or services and revenue attributable to the material right is recognized when those future goods or services are transferred or when the option expires.

17. As noted in FASB ASC 606-10-55-43, options to acquire additional goods or services at a price that reflects the standalone selling price do not provide the customer with a material right. Options included in contracts with the USG are typically negotiated at standalone selling prices because pricing is established based on costs to complete the contract scope plus a reasonable margin.

18. If an entity determines that an option provides a customer with a material right that is then accounted for as a performance obligation, in accordance with FASB ASC 606-10-32-29 an entity is required to allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis. This would include allocating a portion of the transaction price to the option.

19. As explained in FASB ASC 606-10-55-44, the estimate of the standalone selling price of a customer option should reflect the discount that the customer would obtain when exercising the option, adjusted for both any discount that the customer could receive without exercising the option and the likelihood that the option will be exercised. FinREC believes the estimate of the standalone selling price of a customer option should also reflect the average purchase price of additional products provided by the option.

20. FASB ASC 606-10-55-45 provides a practical alternative to allocating transaction price to an option. If a customer has a material right to acquire future goods or services that are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, the transaction price can be allocated to the optional goods or services by reference to the goods or services expected to be provided. Typically, those types of options are for contract renewals.

21. The assessment as to whether or not an option grants a customer a material right is completed at contract inception. No re-assessment of material rights is required, even in cases where performance issues or cost increases may result in a reduction in expected contract margins. Reduced margin due to actual performance on a contract (that has options) in relation to other contracts for similar products or services does not result in a material right being granted to that customer because the customer did not pay in advance for the future goods or services.

Accounting for customer's exercise of a material right

22. In accordance with FASB ASC 606-10-25-23, an entity recognizes revenue as the amount allocated to the material right when the future goods or services are transferred or when the option expires.

23. At the March 30, 2015 FASB IASB TRG meeting, the accounting for an option representing a material right upon exercise was discussed (TRG Agenda Ref. No. 32). As explained in paragraphs 11 and 12 of the Agenda Ref. No. 34 - March 2015 Meeting – Summary of Issues Discussed and Next Steps, on Issue 1: How should an entity account for a customer's exercise of a material right?:

> TRG members agreed with the staff view that the guidance in the standard could be interpreted to support the following views.
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> > View A: At the time a customer exercises a material right, an entity should update the transaction price of the contract to include any consideration to which the entity expects to be entitled as a result of the exercise. The additional consideration should be allocated to the performance obligation underlying the material right and should be recognized when or as the performance obligation underlying the material right is satisfied.
> >
> > View B: The exercise of a material right should be accounted for as a contract modification. That is, the additional consideration received and/or the additional goods or services provided when a customer exercises a material right represent a change in the scope and/or price of a contract. An entity should apply the modification guidance in paragraphs 606-10-25-10 through 25-13.
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> Although most TRG members thought both Views A and B were supportable by the new revenue standard, most TRG members leaned toward View A. Other TRG members thought that View B could be acceptable based on the definition of a contract modification in the standard. The staff agrees with TRG members that both View A and View B could be in accordance with the guidance in the new revenue standard, depending on the facts and circumstances. TRG members observed that in most, but not all, cases the financial reporting outcome of applying View A or View B would be similar. Only in cases in which the optional goods or services are determined to be not distinct from the original promised goods or services, would the results appear to differ. The staff thinks that an entity typically would conclude that an optional good or service is distinct. The method used to account for the exercise of a material right will depend on the facts and circumstances of the arrangement. TRG members agreed with the staff view that the method used should be applied consistently by an entity to similar types of material rights with similar facts and circumstances.

Differentiating between an option and variable consideration

24. Determining whether a contract contains an option to purchase additional goods and services or includes variable consideration based on a variable quantities (such as an indefinite delivery/indefinite quantity (IDIQ) contracts within the aerospace and defense industry) will require entities to exercise judgment.

25. While the accounting for a contract that contains an option to purchase additional goods and services and a contract that includes variable consideration may result in only minimal differences in the timing and measurement of revenue recognized in a reporting period, there could be differences in required disclosures. Further, the determination can result in significant differences in the amount and timing of revenue recognized in a reporting period when contracts contain multiple performance obligations.

26. While judgment will sometimes be needed to distinguish between contracts with an option to purchase additional goods or services and contracts that have variable consideration, at the November 9, 2015 FASB IASB TRG meeting discussed the accounting for customer options for additional goods and services (TRG Agenda Ref. No. 48). Paragraph 9 of TRG Agenda Ref No. 49 - November 2015 Meeting – Summary of Issues Discussed and Next Steps, noted the following:

> TRG members agreed that an important first step to distinguishing between optional goods or services and variable consideration for promised goods or services is to identify the nature of the entity's promise to the customer as well as the enforceable rights and obligations of the parties. With an option for additional goods or services, the customer has a present right to choose to purchase additional distinct goods or services (or change the goods and services to be delivered). Prior to the customer's exercise of that right, the vendor is not presently obligated to provide those goods or services and the customer is not obligated to pay for those goods or services. In the case of variable consideration for a promised good or service, the entity and the customer previously entered into a contract that obligates the entity to transfer the promised good or service

and the customer to pay for that promised good or service. The future events that result in additional consideration occur after (or as) control of the goods or services have (or are) transferred. When a contract includes variable consideration based on a customer's actions, those actions do not obligate the entity to provide additional distinct goods or services (or change the goods or services to be transferred), but rather, resolve the uncertainty associated with the amount of variable consideration that the customer is obligated to pay the entity. TRG members thought that the staff paper provided a useful framework for evaluating the issue, but that judgment will be required in many cases.

Unexercised options in a loss position

27. Existing industry guidance provides for the inclusion of contract options that are probable of exercise in the determination of a loss and related provision. FASB ASC 605-35-25-46 (as amended for FASB ASC 606) states "When the current estimates of the amount of consideration that an entity expects to receive in exchange for transferring promised goods or services to the customer, determined in accordance with ASC 606, and the contract indicates a loss, a provision for the entire loss on the contract shall be made".

28. FASB ASC 605-35-25-46A (as amended for FAB ASC 606) also states, "For the purpose of determining the amount that an entity expects to receive in accordance with paragraph 605-35-25-46, the entity shall use the principles for determining the transaction price in paragraphs 606-10-32-2 through 32-27 (except for the guidance in paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration) and allocating the transaction price in paragraphs 606-10-32-28 through 32-41".

29. Therefore, stakeholders may interpret that FASB ASC 606 would not require entities to record a provision for losses relating to contractual options that are probable of exercise. However, FinREC believes the Boards intent in amending and retaining the guidance in ASC 605 on accounting for contract losses was that the accounting would not change compared to current industry guidance. Therefore, FinREC believes entities should continue to include losses on options which are probable of exercise in determining the provision for losses on contracts, consistent with current industry guidance. Additionally, consistent with current guidance, entities would not include profitable options that are probable of exercise when determining the amount of the provision for loss on an existing contract.

30. The following examples are meant to be illustrative, and the actual determination of the appropriate method for accounting for the contract modification as stated in FASB ASC 606-10-25-10 should be based on the facts and circumstances of an entity's specific situation.

Example 1: Modification – the sale of additional products upon exercise of option

Part 1 – Option is distinct

31. A contractor enters into an arrangement with the government to sell 1,000 rocket launchers for $10M ($10,000 per rocket launcher), with an option to purchase an additional 500 rocket launchers for $10,000 each. The option does not include a material right because the price of the additional rocket launchers represents the standalone selling price The rocket launchers are transferred to the customer over a six-month period. The contractor has concluded that all 1,000 rocket launchers represent a single performance obligation as the entity is responsible for the overall management of the contract, which requires a significant service of integration of various activities, including procurement of materials, identifying and managing subcontractors, and performing manufacturing, assembly, and testing for all rockets. The parties modify the contract in month six upon exercise of the government's option to purchase the additional 500 rocket launchers for $10,000 each.

32. Based on the specific facts and circumstance, the entity may conclude that the modification to sell the additional 500 rocket launchers at $10,000 each should be accounted for as a separate contract in accordance with FASB ASC 606-10-25-12. The additional rocket launchers are distinct because the modification will be managed separately due to the existing contract being substantially complete and the price for the additional rocket launchers reflect their standalone selling price.

Part 2 – Option is not distinct

33. In this example, if the customer exercises the option in month one, the entity may conclude that the modification to sell the additional 500 rocket launchers at $10,000 each should be accounted for as part of the existing single performance obligation because of the significant integration service that will be provided to manufacture and produce the 1,500 rocket launchers over the same period of performance.

Example 2: Modification – extending a services contract at a price that doesn't represent standalone selling price

34. An entity enters into a contract to provide a customer with logistic support services for three-years for $450,000 per year. For the purposes of this example, it is assumed that the entity determines that based on the nature of the service (that is, providing a service that is available for a customer to use as and when the customer decides) it was providing the customer a series of distinct services that are substantially the same and have the same pattern of transfer. Therefore the entity concludes that, for the purposes of this example, it should recognize the three years of service as a single performance obligation (that is, a series of distinct services). The original contract does not provide the customer the option to renew the contract after the three-years. The standalone selling price for the service at inception of the contract is $450,000 per year.

35. At the end of the second year, the parties agree to modify the contract as follows: (1) the fee for the third year is reduced to $360,000; and (2) customer agrees to extend the contract for another three years for $900,000 ($300,000 per year). The standalone selling price of the services at the time of modification is $360,000.

36. Based on the specific facts and circumstances in this example, the entity believes that the modification should not be accounted for as a separate contract. The price of the contract did not increase by an amount of consideration that reflects the standalone selling price of the additional services, even though the additional services are distinct.

37. Revenue for the modified contract is recognized prospectively over the modified service period (which is the last year remaining under the original contract plus the three additional years). The entity should reallocate the remaining consideration to all of the remaining services to be provided. This results in $315,000 (calculated as $360,000 re-negotiated fee for the final year of the original contract plus $900,000 contract modification divided by 4 years) being recognized in each of the remaining years.

38. An entity will account for a contract modification prospectively if the contract contains a single performance obligation that is made up of a series of distinct goods or services. To account for the modification prospectively, the entity's performance completed to date must be separable from its remaining performance obligations (that is, the remaining promised goods or services in the modified contract are distinct from goods or services previously provided to the customer).

Example 3: Modification – additional promise is not distinct

39. A contractor enters into a contract to design an unmanned aerial vehicle and manufacture ten identical prototype units for $2 billion. The new design includes certain key functionality that has not been proven. It is expected that the design will be modified during production of the prototypes and that any given prototype might be modified based on the design changes and learnings from another prototype. The deliverable to the customer is the prototype units; the customer does not obtain rights to the new design apart from the units. The contractor has evaluated the design services and manufacturing of the prototypes (design and build) as a single performance obligation as the contractor provides a significant service of integrating goods or services promised in the contract and some of these goods and services could significantly modify or customize others in the contract. In this particular fact pattern, the entity expects to continually modify the prototypes due to design changes that are expected to occur during production. While the design and production might have benefits on their own, in the context of the contract, the contractor has determined that they are not separable. This is because the entity has determined both the design and production are highly dependent on and highly interrelated with each other. At the end of year one, the contractor and customer agree to modify the original design plan, which increases the expected revenue and expected cost by approximately $300M and $275M, respectively.

40. Based on the specific facts and circumstances in this example, the entity believes that the modification does not create a distinct good or service and the remaining design and production of prototypes to be provided under the modified contract are not distinct from the services already provided. The contractor should account for the modification as if it were part of the original contract and update its measure of progress and estimates to account for the effect of the modification. This will result in a cumulative catch-up adjustment at the date of the contract modification.

Example 4: Modification – Unpriced change order

41. A contractor enters into a contract with a customer to develop a satellite. After development starts, the customer changes the specifications of the satellite. The contractor is asked to process the changes; however, the price has not yet been approved and is not expected to be approved before the development is completed. These types of changes are common and the contractor has a history of executing unpriced change orders with this customer that it believes is predictive of future prices.

42. The changes in the satellite specifications will be accounted for when a contract modification exists. A contract modification, such as an unpriced change order, exists when the parties to the contract approve a modification that creates or changes the enforceable rights and obligations of the parties. Determining whether there is a valid expectation that the price for the modification will be approved is based on specific facts and circumstances. The contractor may be able to determine that it expects the price of the scope change to be approved based on its experience with a particular customer. If so, the contractor will estimate the change in transaction price based on a probability-weighted or most likely amount approach (whichever is most predictive), provided that it is probable that a significant reversal in the cumulative amount of revenue recognized will not occur when the price of the change order is approved. Estimates of unpriced change orders need to be re-evaluated at each reporting period.

43. The contractor will also need to determine whether the change order should be accounted for as a separate contract.

Example 5: Modification – Claims

44. A contractor enters into a contract for the deployment and installation of radar systems for the government. Due to reasons outside of the contractor's control (for example, customer-caused delays), the cost of the contract far exceeds original estimates. The additional costs do not result in the addition of distinct goods or services. The contractor submits a claim against the government to recover a portion of these costs. The claim process is in its early stages, but the contractor has a long history of successfully negotiating claims with the government.

45. Based on the contractor's history of successfully negotiating claims with the government, it assesses the legal basis of the claim and determines that it has enforceable rights. The contractor would account for the claim as a contract modification. The contractor determines that since the modification did not result in the addition of distinct goods or services that the adjustment to revenue should be made on a cumulative catch-up basis. The contractor updates the transaction price and the calculation of progress toward completion for the performance obligation. The contractor also considers the constraint on estimates of variable consideration when estimating the transaction price.

46. In making the above assessments, the contractor would evaluate factors such as whether the amount of consideration is highly susceptible to factors outside of their control, relevant experience with similar claims, the period of time before resolution of the claim, past practice of negotiating an amount less than the entire claim, etc. to determine the likelihood or magnitude of a revenue reversal for the variable consideration. The contractor may need to obtain advice from legal counsel regarding the likelihood of prevailing on its claim. Some or the entire variable consideration for the claim is included in the transaction price if the contractor believes that it is probable that cumulative revenue recognized would not be subject to significant reversal in future periods. For performance obligations satisfied over time, this results in some or the entire claim amount being included in the calculation of revenue when the measure of progress is applied. Amounts included in the transaction price will be updated until resolution of the claim.

Example 6: Modification – the sale of additional products

Part 1

47. A contractor enters into an arrangement with the government to sell 2 highly specialized radars for $10M ($5M per radar). It is anticipated that 2 additional radars will be added to the contract through a contract modification. The radars are developed to replace and improve existing functionality and function with an original radar system already owned by the government so the network is operational continuously (i.e. not all 4 radars are needed for a functional system). Radars 1 and 2 were produced concurrently, on the same production line, with shared labor, materials, logistics and program management over a four-year period and thus were determined to represent one performance obligation.

48. Shortly after the initial contract award, a modification for an additional radar (Radar 3) is secured for $5 million. Due to the timing of award, Radar 3 will be produced concurrently and will share labor, materials, and program management with Radars 1 and 2.

49. Based on the specific facts and circumstance in this example, the entity believes that the modification to sell the additional radar does not represent a distinct good or service due to the additional radar not being distinct in the context of the contract and should be combined with the original contract. The production of the three radars are considered highly interdependent and highly interrelated to each other. The measure of progress and estimates

to account for the effect of the modification should be updated, resulting in a cumulative catch-up adjustment at the date of the contract modification.

Part 2

50. In year 4 of the contract, a modification for 2 additional radars is secured for $5M each, which represents standalone selling price on the modification date. When the contract is modified to add 2 additional radars, Radar 1 is already in full operational use and Radars 2 and 3 are in the final stages of testing before deployment. Due to the timing of the modification, the 2 additional radars will be produced separately with no overlapping materials, logistics, testing or program management with the original 3 radars.

51. Based on the specific facts and circumstance in this example, the entity believes that the modification to sell the additional 2 radars at $5M each should be accounted for as a separate contract because the additional radars are distinct, the price for the additional radars reflects standalone selling price, and the existing contract would not be affected by the modification.

Example 7: Modification: Additional services are not distinct

52. A contractor enters into a contract to develop a global security program to be used at points of entry across the globe for the customer. The new program has certain key functionality that has not been proven. The contract is structured with a base Phase 1 and options to execute additional phases to complete the fully integrated program as the customer obtains funding. The first phase includes the design of the security program. After phase 1 begins, the customer issues three modifications which turn on the options for including the development, production, and initial support phases of the program. The activities in each phase overlap each other and are highly inter-related (i.e. production begins during development, issues during development lead to changes in design, the support phase could lead to changes in design and development, etc.). While the phases might have benefits on their own, in the context of the contract, the contractor has determined that they are not separable because they are highly inter-related. For the customer to have a functioning global security network, all modifications and phases are required.

53. Based on the specific facts and circumstances in this example, the entity believes that each modification is accounted for as if it were part of the original contract upon exercise. As the phases are highly inter-related, they are not distinct from each other. Each modification should be treated as part of the existing contract. The adjustment to the contract price and measure of progress should be accounted for as a cumulative catch-up adjustment at the date of the modification.

Example 8: Option: Material Right

54. A contractor is awarded a contract to design and qualify a new product, with an option for full rate production of the new product. Profit margin is bid at 10% for the non-recurring design and qualification effort, but at a loss of (2%) for the full rate production. Full rate production for similar products for similar customers is typically priced at 15%. In this example, the option for full rate production is likely a material right because the entity agreed to a reduced margin on the full rate production compared to similar contracts for similar customers, and it is assumed that this discount is material in the context of the contract. It is also assumed in this example that the effort expended by the contractor under the full rate production option and full rate production for similar products for similar customers are the same, and excludes non-recurring design and qualification work in each case.

55. Therefore, the contractor should consider the material right to be a separate performance obligation, and should allocate the transaction price between the two accordingly, in accordance with FASB ASC 606-10-55-41 through 55-45 and FASB ASC 606-10-32-28 through 32-41.

Example 9: Option: Material Right with low probability of exercise

56. An entity enters into a contract to sell two helicopters to a large metropolitan police force, with an option for a third helicopter with a discount of 20% off the selling price, which is not offered to similar customers for similar products. The customer has never owned and operated more than two helicopters at one time due to operational needs and budgetary constraints. Further, the entity believes it is unlikely that the customer will exercise the option for the third helicopter. In this example, the low probability of the exercise does not eliminate the customer's material right. The option to purchase the third helicopter at a discount represents a material right because paying the full price for the first two helicopters results in the customer effectively paying in advance for the discounted third helicopter.

57. The low probability that the customer will exercise the option should be factored into the determination of the amount to be allocated to the material right related to the option. In other words, the low probability of the option's exercise should result in a much lower allocation of the transaction price to the material right.

Comments should be received by March 1, 2017, and sent by electronic mail to Kim Kushmerick at kkushmerick@aicpa.org, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.