A&D roundtables

Our Aerospace & Defence roundtables are part of an EY exclusive, invite-only programme that brings together Finance leaders from key industry players in Europe. The objective is to build a community to share points of view and best practice on arising topics in accounting, regulation, tax or advisory and to engage discussions on new trends in the industry.

As part of this, our most recent event brought together 12 leading A&D companies with revenues over £2bn in two roundtable events. The first of which was held on 24 November 2015 in London and the second on 4 March 2016 in Paris where we discussed the difficulties and opportunities related to the implementation of the new revenue recognition standard, IFRS 15. Facilitated by EY industry leaders and IFRS 15 experts, the roundtables also gained valuable input of IASB and FASB task force members.

This paper summarises the key points debated during these meetings.

Join our next roundtable on 23 September in London!

IFRS 15 and IFRS 16 will be on the agenda.

To register, please contact Sarah Kokot at skokot@uk.ey.com
The adoption of the new revenue recognition standard is more than a pure accounting exercise

Participants acknowledged that the impact extends across the business, with potentially significant effects on IT systems and key performance indicators used for internal management reporting but also for external communication.

For example, there is a discussion on the possibility of continuing to apply milestone accounting, a practice common in the industry consisting of using technical milestones to measure the progress of completion (output method) rather than the costs incurred (input method). Abandoning this method for a move to the cost to cost approach would require a major change in reporting systems.

The new requirements in terms of disclosures were also discussed within the group. Strict rules regarding backlog information will imply a different reporting process including data not necessarily disclosed today, like the horizon of future recognition.

Key questions to be considered

- How do you plan to train your teams and organise the transition?
- Do you have the right project team in place?
- What are the main differences affecting your current revenue recognition policy?
- Are your systems ready to provide the additional data you might need (for instance for disclosures)?
- Have you involved your Legal Department to review contractual clauses?
A long journey but will arrive sooner than you think

The implementation of the new standard is a long journey because it involves many departments and may change some key performance indicators. Participants are not at the same stage and can be split in three groups based on the maturity of their project:

► **Group A** has not yet started its detailed analysis and either considers the expected impact as minimal and/or await some guidance from the industry

► **Group B** started a few months ago and has performed a detailed analysis, either on a selection of key contracts and/or on a Division where the most impact is expected

► **Group C** has already launched some simulations, exploring the impact of various options. Participants in this group are expecting a significant impact on their accounts and the management and the audit committee are deeply involved
So still a long way to go for most industry players to be ready for an implementation in January 2018

For companies with a year end closing of December and applying the full retrospective approach, only nine months are left before the start of comparative data calculation! The second half of 2016 will be critical to freeze options and perform simulations.

Tips for a successful implementation

► Stakeholder approval is key. Spend time with them and keep it simple
► Analysis paralysis: Don’t let the lack of an accounting answer hold up the rest of the implementation plan. Keep resolving other accounting issues and data needs
► When data is not easily available to calculate IFRS 15 figures, you need a data remediation plan. Identify data gaps early
► Plan for ‘surprises’. Typically, these are extra analysis and demands from stakeholders
The analysis of the legal clauses sits at the core

To support a transfer of control over time under IFRS 15, most A&D contractors need to demonstrate that the asset has no ‘alternative use’ and that the seller has an enforceable right to payment in case of termination for convenience by the customer, at any time, including a reasonable profit margin.

Such a demonstration implies a detailed legal analysis of the existing contracts, with a categorisation in case of a diversity of clauses. This analysis should be performed early in the process, involving the legal department to draw the appropriate picture. Whereas contracts with Ministries of Defence usually include a clause supporting this right to payment, the portfolio of contracts can show various types of contractual arrangements.

As there is no definition of what is a reasonable profit margin, some judgement is required to conclude. In particular, the contractual definition of eligible ‘costs’ for the application of indemnification/cost recovery clauses.

Participants highlighted that termination for convenience occurs very rarely and when it does occur it gives rise to a negotiation with the customer, whatever the contractual clauses, usually providing compensation for the contractor. However, even if there is an history of successful negotiations, evidencing enforceable rights is key as IFRS 15 only considers the contractual rights and obligations.

Only 30% of the participants have already performed a detailed analysis of the contractual clauses. Some of them have derived from this work some clear recommendations for negotiating future contracts whilst considering the business constraints.

An opportunity to get higher legal protection in the contract and to better comply with IFRS 15 requirements.
Some of the key questions debated

How to assess if there is a significant financing component?

Participants raised the difficulty in assessing whether there was a significant financing component linked to the advance payments received from their customers.

Let’s consider the advance payment in commercial aircraft contracts: are they made to secure an aircraft production slot or for the provision of finance? Aircraft manufacturers do not have sufficient production volumes to fill the demand. Therefore, airlines are securing slots via pre-delivery payments. The participants suggested that the customer’s ability of to sell/transfer such a slot to a third party without requiring the prior approval and involvement of the manufacturer shall be considered in the assessment. If that is the case, shall this slot securing be considered as a separate performance obligation?

Similarly, most participants consider that advance payments received from customers are intended as a protection against payment default and often do not present a financing component.

Variable consideration: towards more prudence?

Under current standard, contract revenues shall comprise variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

IFRS 15 introduces a rule of further prudence, from probable to highly probable and increases the burden of proof as it relates to the predictive feature of the outcome.

With respect to incentives and penalties, in many cases, it should not imply major changes on how these elements are considered today, as many companies are already conservative in the way they include them in the revenue at completion. However, IFRS 15 requires a clear documentation (burden of proof) as to why the entity has determined that it is highly probable that it will receive the amount of variable consideration.

Regarding price escalation, it is important to understand what the rationale behind escalation is. Usually, it is a reflection in the price of the expected increases in material and labour costs. Therefore it is crucial to have a symmetrical approach between price and cost escalation to come to a sensible accounting.
Can technical milestones still be used to measure progress?

A lot of A&D entities use milestones reached as a measure of progress when recognising revenue over time. Under current practice, such entities typically recognise work in progress in respect of work performed between milestones. The implication of using milestones reached is that in some circumstances control may transfer discretely, but progressively, over time, a situation that is not directly addressed by the new standard.

There is a widespread view that milestone accounting, where material work in progress is recognised, will be difficult to justify as an appropriate method of measuring performance under IFRS 15.

However most participants support milestone accounting and are hoping to continue this practice under IFRS 15. They consider it to provide a better view of the progress achieved and is more relevant in terms of controlling the costs incurred.

To clarify the requirements, an implementation issue was submitted to the FASB/IASB Transition Resource Group.

Update from April 18 FASB Transition Resource Group meeting:

Some stakeholders have questioned how control transfers over time and the possibility to have the transfer occurring at discrete points in time, therefore justifying the milestone accounting to measure progress on a long term contract.

The TRG concluded that when control transfer over time, it does not transfer at discrete points in time. Accordingly, an appropriate measure of progress should not lead to a material asset that results from an entity’s performance (for example, work in progress) being recognised by the entity.

In addition, they clarified that:
- There can be some inventories before the customisation phase starts because at this stage the inventory can be allocated to a different customer
- In this case, the revenue recognition should start only when the customisation starts, as this is when the two cumulative conditions of §35(c) of IFRS 15 are fulfilled (enforceable right to payment and no alternative use)

Risk sharing arrangements: collaborative agreements or vendor/customer relationship?

In aircraft engine manufacturing, it is quite common to have long-term arrangements whereby the development and production of an engine for a new type of aircraft is organised by a risk and revenue sharing arrangement concluded between the Original Equipment Manufacturer (OEM) and the supplier.

Generally, participants see these arrangements as revenue generating activities within the scope of the standard for revenue recognition, in line with their current accounting.

Treatment of costs such as participation fees represents a distinct element which needs to be considered in these arrangements. IFRS 15 constrains treatment of some of these payments because it forces them to be viewed as consideration payable to a customer which results in a reduction of revenue, whereas these may have historically been treated as intangibles under IAS 38 and amortised over the life of the arrangement.
What is changing for onerous contracts accounting?

IFRS 15 does not include any guidance on the accounting treatment of onerous performance obligations or contracts but explicitly extends the scope of IAS 37 to onerous contracts resulting from contracts with customers according to IFRS 15.

According to IAS 37 the provision has to be determined as the lower of the net costs of fulfilling the contract and the costs of terminating it (unavoidable costs), even if the entity intends to fulfil the contract. An assessment of the costs of terminating the contract is particularly relevant in cases when companies have a termination for convenience right.

The loss making position is assessed at contract level and not at each performance obligation level.

Therefore, a loss making performance obligation does not need to be accrued for if compensated by profitable performance obligations within the same contract. Further, IAS 37 requires presenting the amount of a provision at present value where the time value of money is material which was not the case when applying IAS 11.

Backlog disclosures: how to comply in a sensible way?

Most A&D companies already disclose information on their order intake and order book. It is a key performance indicator in the industry and sensitive data.

Today, this information is presented outside the financial statements and is not comparable between companies in the absence of common definition. IFRS 15 requires some specific backlog disclosures included in the audited financial statements with a common definition of an enforceable contract and a transaction price (contractual price versus catalogue price).

The horizon of recognition of the remaining revenue, on a quantitative (using time bands) or qualitative basis shall also be provided. Companies have to provide information on significant estimates made regarding variable considerations, either quantitatively or qualitatively. For instance, consideration of termination rights, incentives or penalties, and options.

Participants raised that the requirements under IFRS could result in some remaining performance obligations being included with others being excluded. For instance, a time and material based contract would not imply disclosing the outstanding revenues whereas a ‘power by the hour’ contract would, in spite of potentially delivering the same goods and services.

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