ASC 606: Revenue from Contracts with Customers

Erin Roberts, Americas Leader of Engineering & Construction

September, 2017
Countdown to adoption

2.2 months

- Mandatory adoption
- Calendar year-end public entities
The AICPA has published an overall guide to implementing the new revenue recognition standard, including a chapter from each industry group.

A&D and E&C industries have separate committees.

Published:
Issue #4-1: Identifying the Unit of Account
Issue #4-2: Variable Consideration
Issue #4-3: Acceptable Measures of Progress
Issue #4-4: Uninstalled Materials
Issue #4-5: Impact of Termination for Convenience on Contract Duration
Issue #4-7: Disclosures

In process:
Contract costs, fulfillment costs, including mobilization – cleared by FinREC on 9/13
Potential changes in accounting in the E&C industry

- **Step #1: Identifying the contract**
  - Contract modifications – change orders, claims and progressive scope

- **Step #2: Identification of performance obligations**
  - Design Build Operate Maintain – 2 performance obligations
  - EPCI – If installation significantly modifies the equipment, there is a significant integration service, or the installation could not be performed by someone else, then installation is not a separate PO
  - Extended performance guarantees would be separate performance obligations, and accounted for over term
  - Development fees on PPP projects earned by the entity might be considered a separate performance obligation, resulting in accelerated revenue recognition when earned
  - Multiple assets with limited integration service would be considered multiple Pos, and therefore separate units of account

- **Step #3: Variable consideration**
  - Incentives and liquidated damages – affects revenue by inclusion in the transaction price earlier
  - Claims and the constraint – claims are not limited to costs, which might accelerate revenue and margin

- **Step #5: Recognizing revenue over time**
  - Physical transfer of control vs “effective” transfer of control
  - Application of the right to invoice practical expedient to reimbursable-type contracts
  - Measures of progress (Method B, wasted effort, uninstalled materials)
  - Output methods (units, labor multiplier, milestones, physical, etc.)

- **Contract Costs**
  - Precontract costs can be capitalized if recoverable
    - Incremental costs are costs that would not have been incurred if the contract had not been obtained (e.g. commissions) are capitalized and amortized over duration of the contract
  - Costs to fulfill a contract incurred prior to transfer of control (mobilization) are capitalized and amortized over duration of the contract
The new revenue recognition model
Step 1 – Contract modifications

- A contract modification is any change in the scope and/or price of a contract (change orders and claims)
- Accounting treatment depends on what was modified

<table>
<thead>
<tr>
<th>Separate contract</th>
<th>Part of original contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of the contract changes due to added goods or services that are distinct (i.e. a separate performance obligation) And Price of the contract increases by the standalone selling price</td>
<td>All other modifications Cumulative affect accounting</td>
</tr>
</tbody>
</table>
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The new revenue recognition model
Step 2 – Determining if goods or services are distinct

Step 2: Identify the performance obligations in the contract

Two-step model to identify which goods or services are distinct

Step 1 – Focus on whether the good or service is capable of being distinct

Customer can benefit from the individual good or service on its own

or

Customer can use good or service with other readily available resources

Step 2 – Focus on whether the good or service is distinct in the context of the contract

The good or service is not integrated with, highly dependent on, highly interrelated with, or significantly modifying or customizing other promised goods or services in the contract
Engineering and construction (E&C) contracts often provide multiple goods and/or services to a customer.

Contracts for design build operate maintain (DBOM) projects have multiple services that must be evaluated to determine if the goods and services represent multiple performance obligations.

- Evaluate if the separate goods and services are significantly interrelated (affect each other) or there is a significant integration service being performed by the contractor – usually true for DB.
- Operation and maintenance (OM) is most often a separate performance obligation from the design/construction.

Evaluate whether a series of goods contracted for under a single contract should be grouped (e.g., contract to construct 10 land rigs).

Installation is a possible PO if installation significantly modifies the equipment.
The new revenue recognition model
Step 2 – Warranties

Step 2: Identify the performance obligations in the contract

► Warranties
  ► Assurance-type warranties
  ► Service-type warranties
► If the customer has the option to separately purchase the warranty, it represents a separate performance obligation
► If the customer does not have the option to separately purchase the warranty, accrue for the expected warranty costs unless the services under warranty are beyond “quality assurance” services
► Factors to consider when determining whether a warranty promise provides more than “quality assurance” include:
  ► Whether the warranty is required by law
  ► Length of time covered by the warranty
  ► The nature of the tasks to be performed under the warranty promise
► Guidance is similar to current US GAAP
Potential changes in accounting in the E&C industry

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The new revenue recognition model
Step 3 – Components of the transaction price

Step 3: Determine the transaction price

- Transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer

- Transaction price includes the effects of the following:
  - Variable consideration (including application of the constraint)
  - Significant financing component
  - Consideration paid to a customer
  - Noncash consideration
The new revenue recognition model

Step 3 - E&C – Contractor considerations

Step 3: Determine the transaction price

- Awards and incentive fees
  - Variable consideration (most likely amount/expected value)
  - Application of the constraint (differences from estimates in 605-35)
- Liquidated Damages and Schedule Bonuses
- Retainage
  - Generally for a reason other than financing
  - Entities should evaluate whether amounts are “true” retainage
The new revenue recognition model
Step 3 – Estimating variable consideration

**Step 3: Determine the transaction price**

- Transaction price may vary because of variable consideration (e.g., bonuses, liquidated damages, rebates, incentives)
- The transaction price is estimated using the approach that better predicts the amount to which the entity is entitled based on its facts and circumstances (i.e., not a “free choice”)

<table>
<thead>
<tr>
<th>Expected value</th>
<th>Most likely amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Sum of the probability-weighted amounts in a range of possible outcomes</td>
<td>► The single most likely amount in a range of possible outcomes</td>
</tr>
<tr>
<td>► Most predictive when the transaction has a large number of possible outcomes</td>
<td>► May be appropriate when the transaction will produce only two outcomes</td>
</tr>
<tr>
<td>► Can be based on a limited number of discrete outcomes and probabilities</td>
<td></td>
</tr>
</tbody>
</table>
The new revenue recognition model
Step 3 – Constraining variable consideration

**Step 3:** Determine the transaction price

- Required to evaluate whether to “constrain” amounts of variable consideration included in the transaction price
- Objective of the constraint – include variable consideration in the transaction price only to the extent it is “probable” that a significant revenue reversal will not occur when uncertainty is subsequently resolved
  - “Significant” is relative to cumulative revenue recognized on the contract
  - Impact of claims accounting
Step 3: Determine the transaction price

An entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

► The amount of consideration is highly susceptible to factors outside the entity’s influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

► The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

► The entity’s experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

► The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

► The contract has a large number and broad range of possible consideration amounts.
The new revenue recognition model
Step 3 – Other transaction price considerations

**Step 3:** Determine the transaction price

Significant financing component
- The time value of money is considered when significant, and the primary purpose of the payment terms is to provide financing to counterparty
  - Evaluation not required if customer is expected to pay within one year of when control of the goods or services is transferred

Noncash consideration
- Measured at the fair value of the consideration received or promised.
- Customer furnished materials – principal or agent?
Potential changes in accounting in the E&C industry

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The new revenue recognition model
Step 4 – Stand-alone selling price

Step 4: Allocate the transaction price to the performance obligations

- Transaction price is generally allocated to each separate performance obligation on a relative stand-alone selling price basis
- When a stand-alone selling price is not observable, an entity is required to estimate it
  - Maximize the use of observable inputs
  - Apply estimation methods consistently in similar circumstances
  - Standard describes three estimation methods but others are permitted (and a combination of estimation methods is allowed)
    - Adjusted market assessment approach
    - Expected cost plus a margin approach
    - Residual approach
- Stand-alone selling prices used to perform the initial allocation should not be updated after contract inception
The new revenue recognition model
Step 4 – E&C – Allocate variable consideration

**Step 4:** Allocate the transaction price to the performance obligations

- Circumstances in which E&C entities may apply the exception include:
  - A construction contract with multiple performance obligations when variable consideration relates only to one performance obligation
  - Contracts for project management, construction supervision or engineering services that are a series of distinct services that form part of a single performance obligation
  - Awards and incentive fees
    - May be able to allocate to a specific performance obligation (or good or service within a group) if certain criteria are met
Potential changes in accounting in the E&C industry

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The new revenue recognition model
Step 5 – Transfer of control over time

Control of goods and services is transferred *over time* if one of the following three criteria is met:

- The entity creates or enhances an asset that the customer controls as it is created or enhanced.
- The entity’s performance does not create an asset with alternative use, and the entity has a right to payment for performance completed to date.
- The customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs.

If none of the criteria are met, control transfers at a point in time.

“Pure service” contracts

- Another entity would not have to re-perform work completed to date.
  1. Disregard potential limitations that would prevent the transfer of a remaining PO to another entity.
  2. Assume another entity fulfilling the remaining PO would not have the benefit of any asset the entity controls.
The new revenue recognition model
Step 5 – E&C – Progress measures

**Step 5:** Recognize revenue when (or as) each performance obligation is satisfied

- Input methods
  - An entity should exclude from an input method the effects of any inputs that do not depict the entity’s performance in transferring control of goods or services to the customer.
  - An entity would not recognize revenue on the basis of costs incurred that are attributable to **significant inefficiencies** in the entity’s performance that were not reflected in the price of the contract (for example, the costs of unexpected amounts of wasted materials, labor, or other resources that were incurred to satisfy the performance obligation).
Input methods

A faithful depiction of an entity’s performance might be to recognize revenue at an amount equal to the cost of a good used to satisfy a performance obligation if the entity expects that all of the following conditions would be met:

- The good is not distinct.
- The customer is expected to obtain control of the good significantly before receiving services related to the good.
- The cost of the transferred good is significant relative to the total expected costs to completely satisfy the performance obligation.
- The entity procures the good from a third party and is not significantly involved in designing and manufacturing the good.

Evaluation should be performed throughout the term of the contract.
The new revenue recognition model
Step 5 – Progress measures

Step 5: Recognize revenue when (or as) each performance obligation is satisfied

- Practical expedient for measuring progress toward satisfaction of a performance obligation – “right to invoice”
  - If the invoiced amount corresponds directly with the value to the customer of the entity’s performance completed to date, allows an entity to recognize revenue in the amount for which it has the right to invoice
  - Up-front payments or retroactive adjustments that significantly shifts payment to the front- or back-end of a contract, makes it difficult for an entity to conclude that the amount invoiced corresponds directly with the value provided to the customer
  - Presence of an agreed-upon customer payment schedule does NOT mean that the amount an entity has the right to invoice corresponds directly with the value to the customer of the entity’s performance completed to date
- Time and materials engineering services contracts
Potential changes in accounting in the E&C industry

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The new revenue recognition model
Incremental costs of obtaining a contract

- Incremental costs of obtaining a contract would be capitalized if they are expected to be recovered
  - Incremental costs are costs that would not have been incurred if the contract had not been obtained (e.g. commissions)
  - Practical expedient to allow immediate expense recognition if the contract is one year or less in duration
- Amortized consistent with the pattern of transfer of the related good or service and subject to impairment
  - If costs are determined to relate to more than one contract (e.g., expected contract renewals), amortization should consider both current and anticipated contracts
The new revenue recognition model

Costs to fulfill a contract

- Other applicable literature should be considered first (inventory)
- Costs of fulfilling a contract that cannot be capitalized under another standard would be capitalized if they meet all of the following criteria:
  - Relate directly to a contract
  - Generate or enhance resources that will be used to satisfy performance obligations in the future
  - Are expected to be recovered
- Costs of fulfilling a contract would be amortized consistent with the pattern of transfer of the related good or service and would be subject to impairment
  - Mobilization costs prior to any transfer of control should be capitalized
  - Surety bonding
- “Abnormal costs” not considered in the price of the contract would be expensed as incurred
Potential changes in accounting in the E&C industry

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► **Disclosures**
## The new revenue recognition model

### Disclosure requirements summary

<table>
<thead>
<tr>
<th>Category</th>
<th>Subcategory</th>
<th>Information type</th>
<th>Frequency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contracts with customers</td>
<td>Disaggregation of revenue</td>
<td>Quantitative</td>
<td>Interim/annual</td>
</tr>
<tr>
<td></td>
<td>Contract balances</td>
<td>Quantitative</td>
<td>Interim/annual</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Qualitative</td>
<td>Annual</td>
</tr>
<tr>
<td></td>
<td>Performance obligations</td>
<td>Quantitative</td>
<td>Interim/annual</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Qualitative</td>
<td>Annual</td>
</tr>
<tr>
<td>Significant judgments</td>
<td>N/A</td>
<td>Quantitative</td>
<td>Annual</td>
</tr>
<tr>
<td>Contract costs</td>
<td>N/A</td>
<td>Quantitative</td>
<td>Annual</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Qualitative</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>Practical expedients</td>
<td>Qualitative</td>
<td>Annual</td>
</tr>
<tr>
<td></td>
<td>Transition</td>
<td>Quantitative</td>
<td>Interim/annual</td>
</tr>
<tr>
<td></td>
<td>SEC requirements</td>
<td>Quantitative</td>
<td>Interim/annual</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Qualitative</td>
<td></td>
</tr>
</tbody>
</table>
Disclosures - Disaggregated revenues
General Dynamics as an example

Revenue by major product line was as follows:

<table>
<thead>
<tr>
<th>Product Line</th>
<th>Three Months Ended</th>
<th>Six Months Ended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aircraft manufacturing, outfitting and completions</td>
<td>$1,600</td>
<td>$1,842</td>
</tr>
<tr>
<td>Aircraft services</td>
<td>445</td>
<td>404</td>
</tr>
<tr>
<td>Pre-owned aircraft</td>
<td>33</td>
<td>38</td>
</tr>
<tr>
<td>Total Aerospace</td>
<td>2,078</td>
<td>2,284</td>
</tr>
<tr>
<td>Wheeled combat vehicles</td>
<td>566</td>
<td>545</td>
</tr>
<tr>
<td>Weapons systems, armament and munitions</td>
<td>409</td>
<td>355</td>
</tr>
<tr>
<td>Tanks and tracked vehicles</td>
<td>278</td>
<td>238</td>
</tr>
<tr>
<td>Engineering and other services</td>
<td>161</td>
<td>159</td>
</tr>
<tr>
<td>Total Combat Systems</td>
<td>1,414</td>
<td>1,297</td>
</tr>
<tr>
<td>C4ISR* solutions</td>
<td>1,052</td>
<td>1,119</td>
</tr>
<tr>
<td>Information technology (IT) services</td>
<td>1,052</td>
<td>1,096</td>
</tr>
<tr>
<td>Total Information Systems and Technology</td>
<td>2,104</td>
<td>2,215</td>
</tr>
<tr>
<td>Nuclear-powered submarines</td>
<td>1,342</td>
<td>1,278</td>
</tr>
<tr>
<td>Surface combatants</td>
<td>254</td>
<td>282</td>
</tr>
<tr>
<td>Auxiliary and commercial ships</td>
<td>155</td>
<td>152</td>
</tr>
<tr>
<td>Repair and other services</td>
<td>328</td>
<td>266</td>
</tr>
<tr>
<td>Total Marine Systems</td>
<td>2,079</td>
<td>1,978</td>
</tr>
<tr>
<td>Total revenue</td>
<td>$7,675</td>
<td>$7,774</td>
</tr>
</tbody>
</table>
## Disclosures – Disaggregated revenues

### General Dynamics as an example

Revenue by contract type was as follows:

<table>
<thead>
<tr>
<th>Three Months Ended July 2, 2017</th>
<th>Aerospace</th>
<th>Combat Systems</th>
<th>Information Systems and Technology</th>
<th>Marine Systems</th>
<th>Total Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-price</td>
<td>$ 1,913</td>
<td>$ 1,207</td>
<td>$ 892</td>
<td>$ 1,253</td>
<td>$ 5,265</td>
</tr>
<tr>
<td>Cost-reimbursement</td>
<td>—</td>
<td>196</td>
<td>1,018</td>
<td>824</td>
<td>2,038</td>
</tr>
<tr>
<td>Time-and-materials</td>
<td>165</td>
<td>11</td>
<td>194</td>
<td>2</td>
<td>372</td>
</tr>
<tr>
<td><strong>Total revenue</strong></td>
<td>$ 2,078</td>
<td>$ 1,414</td>
<td>$ 2,104</td>
<td>$ 2,079</td>
<td>$ 7,675</td>
</tr>
</tbody>
</table>

Revenue by customer was as follows:

**U.S. government:**

| Department of Defense (DoD) | $ 32 | $ 636 | $ 1,137 | $ 2,016 | $ 3,821 |
| Non-DoD                     |     | 25    | 663     | —       | 688     |
| Foreign Military Sales (FMS)| 9   | 83    | 21      | 40      | 153     |
| **Total U.S. government**   | 41  | 744   | 1,821   | 2,056   | 4,662   |

**U.S. commercial**

| 877 | 42 | 94 | 17 | 1,030 |
| Non-U.S. government           | 64 | 594 | 155 | 4 | 817 |
| Non-U.S. commercial           | 1,096 | 34 | 34 | 2 | 1,166 |
| **Total revenue**             | $ 2,078 | $ 1,414 | $ 2,104 | $ 2,079 | $ 7,675 |
Disclosures – Contract assets and Liabilities
Raytheon as an example

Net contract assets (liabilities) consisted of the following:

The $566 million increase in our net contract assets (liabilities) from December 31, 2016 to April 2, 2017 was due to a $514 million increase in our contract assets, primarily due to the timing of milestone payments on certain international programs.

In the first quarters of 2017 and 2016, we recognized revenue of $612 million and $646 million related to our contract liabilities at January 1, 2017 and January 1, 2016, respectively.

<table>
<thead>
<tr>
<th>(In millions, except percentages)</th>
<th>Apr 2, 2017</th>
<th>Dec 31, 2016</th>
<th>$ change</th>
<th>% change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract assets</td>
<td>$ 5,555</td>
<td>$ 5,041</td>
<td>$ 514</td>
<td>10.2 %</td>
</tr>
<tr>
<td>Contract liabilities—current</td>
<td>(2,605)</td>
<td>(2,646)</td>
<td>41</td>
<td>(1.5)%</td>
</tr>
<tr>
<td>Contract liabilities—noncurrent</td>
<td>(117)</td>
<td>(128)</td>
<td>11</td>
<td>(8.6)%</td>
</tr>
<tr>
<td>Net contract assets (liabilities)</td>
<td>$ 2,833</td>
<td>$ 2,267</td>
<td>$ 566</td>
<td>25.0 %</td>
</tr>
</tbody>
</table>

The $566 million increase in our net contract assets (liabilities) from December 31, 2016 to April 2, 2017 was due to a $514 million increase in our contract assets, primarily due to the timing of milestone payments on certain international programs.

In the first quarters of 2017 and 2016, we recognized revenue of $612 million and $646 million related to our contract liabilities at January 1, 2017 and January 1, 2016, respectively.

Impairment losses recognized on our receivables and contract assets were de minimus in the first quarters of 2017 and 2016.
Status and Questions
What other areas of the Standard do you expect to have to change your policies?

Is there anyone who intends to use the full retrospective method of adoption?

Do you expect a transition adjustment at adoption?

What is the largest impact at adoption that you’ve identified?

Do you intend to disclose the impact of your adoption of ASC 606 in your 2017 10-K?

No amount as still in process

The amount of the impact

A range of the potential impact