

# A new flight plan

What new accounting standards will mean  
for the Aerospace and Defense industry



The first part of the paper discusses the importance of the research and the objectives of the study. It then presents a literature review of the existing research on the topic. The second part of the paper describes the methodology used in the study, including the data collection and analysis techniques. The third part of the paper presents the results of the study, and the fourth part discusses the implications of the findings. The paper concludes with a summary of the main findings and a list of references.

The research was conducted in a systematic and rigorous manner, following the principles of good research practice. The data was collected from a large and diverse sample of participants, and the analysis was conducted using a range of statistical techniques. The results of the study are presented in a clear and concise manner, and the implications of the findings are discussed in detail. The paper is well-written and easy to read, and it provides a valuable contribution to the field of research.

The findings of the study have important implications for the field of research, and they provide a basis for further research. The study also has practical implications, and it can be used to inform policy and practice. The paper is a valuable contribution to the field of research, and it is well-recommended for reading.

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This publication refers to issues specific to the Aerospace and Defense industry. For IFRS issues that cut across all industries, please refer to:

[www.pwc.com/usifrs/publications](http://www.pwc.com/usifrs/publications)

## The heart of the matter

Due to the specialized nature of US GAAP guidance for A&D companies, there may be complex considerations in successfully implementing converged standards and ultimately transitioning to IFRS.

International Financial Reporting Standards (IFRS) have been affecting US companies for some time, whether through their business dealings with non-US counterparties (particularly with customers and vendors), or through their non-US subsidiaries' adoption of IFRS. Soon US companies will also feel the effect of IFRS here at home as key components of US GAAP and IFRS converge. The changes will be many, and swift in coming. To keep pace with them, companies need to start preparing now.

The next several years will bring near-constant change to US financial reporting. IFRS will be the main driver of the change, coming at companies on a variety of fronts:

- **Convergence of key areas of US GAAP and IFRS**
- **Ongoing adoption of IFRS by subsidiaries**, as additional countries switch to IFRS (adoption may be further accelerated due to the issuance of IFRS for small and medium-sized entities (SMEs),
- **Continued influence of IFRS on foreign counterparties' structuring of deals and transactions**, as additional key US trading partners adopt IFRS for capital-market and statutory purposes
- **Ultimate adoption of IFRS in the United States**

#### **Converge → Adopt**

In the meantime, nearly a dozen new standards will converge US GAAP and IFRS by the end of 2011. Fundamental areas to be affected by convergence include debt and equity, revenue, leasing, and consolidation.

As the converged standards start to roll out (they'll do so in quick succession), many US companies and their investors will see major changes in their financial statements. But the impact of the accounting changes caused by convergence, and ultimately by IFRS adoption, will go well beyond financial reporting. Tax policy, mergers and acquisitions, financial planning, systems requirements, and compensation structures are just some of the areas that will be affected.

US companies have a rare opportunity to make time work for them, providing an opportunity to better control costs and understand and manage the challenging scope of IFRS projects.

Aerospace and defense (A&D) companies have specific considerations to address for a successful IFRS transition. Although planning for an IFRS implementation may not be an immediate priority in light of the current economic uncertainty, A&D companies would be wise to take a thoughtful and measured approach to assess what IFRS will mean to them. To help companies do this, this publication summarizes some of the complex accounting areas that are specific to the A&D industry.

An in-depth discussion

The following discussion highlights many of the specific issues A&D companies may face.

The transition to IFRS will have an impact on more than just a company's existing accounting policies and financial reporting. It can also have an impact on a company's underlying processes, systems, controls, tax position and strategy, and even customer contracts and interactions.

For most organizations the transition to IFRS as a result of ongoing convergence and preparation for ultimate adoption will be a fundamental change to how they capture data, process transactions, and report and analyze results. Since most of these organizations rely heavily on technology, this transition will also result in significant changes to their accounting systems and technology environment. For instance, it is not uncommon for a company to go through a multi-reporting period during which IFRS, US GAAP and other local GAAP financial statements are reconciled. Preparing for the implementation of converged standards may result in similar challenges. The ability to meet challenging multi-GAAP reporting requirements largely depends upon the magnitude of the differences between the various standards of accounting, other GAAP and/or regulatory reporting requirements, the capabilities of a company's information systems and the agility of its processes. Other impacts of IFRS to the information systems include changes in configuration settings and data mapping and the longer-term goal to embed changing standards into the business.

Successfully managing the costs of such a change will require management to make smart strategic and tactical decisions early. That means taking steps up front to understand the implications across the company on functions including finance, internal budgeting, information systems, government compliance and legal. Management will have to recognize and plan for the complex layers of interdependency between IFRS and other company-wide projects and regulatory initiatives. The experiences of companies that have already been through an IFRS transition have shown that making strategic decisions early reduces the chance of duplication of efforts, changes in direction and cost overruns at a later stage. The path to a successful transition does contain some pitfalls to avoid, but they go hand-in-hand with opportunities to improve, streamline and/or standardize financial reporting and supporting business processes and systems.

Internal operations may need to change as companies begin to weave the new reporting requirements throughout the fabric of the business - in other words, the various operations and processes that simultaneously feed, and are affected by a company's financial reporting. For instance, control over processes and information may need to be revisited and new treasury strategies devised. To accomplish this, companies may need to enhance resources by hiring new personnel or begin retraining in-house staff. The second alternative is likely to be more economical but will require additional time.

## IFRS issues specific to aerospace and defense

By its nature, the A&D industry generally focuses on large programs with long product life cycles that require significant R&D and capital equipment. Accordingly, the more significant industry-specific issues related to IFRS are associated with revenue recognition and contract accounting, R&D costs, and capital equipment. In addition, defense contractors must consider the unique issues related to government contract accounting and compliance issues related to changes in accounting policies. As such, A&D companies should focus on the impact of converging standards and those aspects of the IFRS adoption that affect long-term contracts and significant programs.

US companies have the advantage of learning from their European colleagues' experience in transitioning to IFRS. Some large A&D companies that already report on IFRS include:

EADS – [www.eads.com](http://www.eads.com)

BAE Systems – [www.baesystems.com](http://www.baesystems.com)

Rolls-Royce – [www.rollsroyce.com](http://www.rollsroyce.com)

Finmeccanica – [www.finmeccanica.com](http://www.finmeccanica.com)

Thales – [www.thalesgroup.com](http://www.thalesgroup.com)

Safran – [www.safran-group.com](http://www.safran-group.com)



# Revenue and profit recognition

## Scope

Many US companies that already report under IFRS use the percentage-of-completion method to recognize revenue. However, US companies should not assume that every contract falling under the scope of Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1) will be within the scope of International Accounting Standard 11, Construction Contracts (IAS 11). IAS 11, as interpreted by International Financial Reporting Interpretations Committee (IFRIC) 15, Agreements for the Construction of Real Estate, applies to “a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.” SOP 81-1 applies to construction and production contracts to a buyer’s specifications. In this regard, determining whether production-type contracts are within the scope of IAS 11 or IAS 18, Revenue, requires the application of judgment. While IFRIC 15 was issued to increase consistency in determining whether real estate agreements were within the scope of the Revenue standard or the Construction Contract standard, the basis for conclusions states that, although the guidance has been developed specifically for the real estate industry, it may be applied by analogy to other situations. Accordingly, the guidance in this interpretation should be considered when making the determination of whether agreements other than for real estate (e.g., A&D agreements) should be accounted for under IAS 11 as a construction contract or under IAS 18 as a sale of goods. This interpretation introduces a “buyer specification” element consistent with existing US GAAP guidance under SOP 81-1. The interpretation indicates that an agreement might meet the definition of a construction contract when the buyer is able to specify the major structural elements of design, but other factors might also be considered.

We believe the following should be considered when evaluating whether a contract qualifies for construction contract accounting under IAS 11:

- **Does the contract specifically involve the construction of tangible assets, or the creation of intangible assets?** If an agreement does not involve the construction of tangible asset(s), or the creation of intangible asset(s) (e.g. an agreement only to provide services), then the agreement would fall within the Revenue standard, IAS 18.
- **Is the agreement for the construction of a combination of assets that are interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use?** Entities should assess whether the totality of assets being produced need to work in collaboration in order to be functional or whether they are needed to make another complex asset function as intended.

Entities often enter into subsequent separate contracts for “replacement parts” of a previously constructed asset. Contracts for such replacement parts should be considered in their own right to determine whether they are construction contracts.

- **Is the contract specifically negotiated with a customer?** If an entity is constructing an asset absent a contract with a specific customer, such contract may not be within the scope of the Construction Contract standard, IAS 11.
- **Is the customer able to specify the major elements of design?** There are a number of factors that an entity should consider in making the determination of whether the customer has specified the major elements of design. The factors listed below are not intended to be all inclusive nor is any one factor intended to be determinative. The preponderance of all factors should be considered in determining whether such buyer specification is present:
  - **Has the customer directed, or can the customer direct at any time, the major structural elements of design?** A customer only needs the ability to direct the major elements of design either before or during construction. It does not necessarily need to exercise such right.
  - **Are the asset(s) being produced either an existing product or a combination of an existing selection of products that the seller already markets?** If the seller is producing the product subject to the contract for the first time, then this may indicate construction is to the buyer's specifications. Conversely, if a product already exists, this may be an indicator that construction is not to the buyer's specifications.
  - **Is the constructed asset, from the perspective of the seller, complex?** If the constructed asset is deemed to be complex from the perspective of the seller, then this may indicate that the asset has been constructed to the buyer's specifications.

The determination of complexity involves judgment and a number of factors might be considered in making such a determination. Examples of such factors might include: (note: such factors are not intended to be all inclusive nor is any one factor intended to be determinative)

- **Are significant R&D or design activities/risks required leading up to, or in the beginning of, a contract with a specific customer?** Such activities in the context of a contract with a specific customer may indicate that, from the perspective of the seller, the construction asset may be complex as well as being to the buyer's specification. R&D within the context of a contract with a specific customer should be differentiated from R&D that is undertaken in furthering the seller's business in general. The undertaking of such general research and development activities would not be an indicator of complexity.
- **Does fulfillment of the contract require a specific and specialized skill set that is not widely available in the marketplace, resulting in limited suppliers or producers with the requisite skills?** If the asset being constructed is complex, then it may follow that the number of entities possessing the necessary skills to execute the contract is limited. Indicators of such a skill set may include specialized equipment, institutional knowledge, and/or proprietary technology and intellectual property.
- **In situations where a seller has entered into multiple contracts over time for the construction of the same asset, is the cost of construction per unit to the seller in earlier contracts significant when compared to later contracts?** As entities enter into subsequent contracts for construction of the same asset, efficiencies and economies of scale will likely make the cost per unit less significant in later contracts than in earlier contracts, potentially indicating that complexity, from the perspective of the seller, has diminished.
- **Are the products sold to a single customer?** Products designed for a single customer, which cannot be used by any other customer, may indicate the significance of the customer's specifications and complexity of the asset.

Contractors must weigh these factors qualitatively and apply sound judgment to determine whether a particular contract is within the scope of IAS 11 or IAS 18. Even if a contract is determined to be within the scope of IAS 11, certain differences exist in the application of percentage of completion under IFRS versus US GAAP.

If an entity determines that an agreement should be accounted for under IAS 18, they may still be able to recognize revenue using a percentage of completion method. IFRIC 15 indicates that, for agreements within the scope of IAS 18, revenue should be recognized using the percentage of completion method when the entity transfers control and the significant risks and rewards of ownership of the work in process as construction progresses. Determining if control and the significant risks and rewards of ownership continuously transfer will require judgment. Factors that might be considered in making this determination include:

- The customer has the ability to sell the asset being constructed under the contract at any point in time during the construction period. That is, they could sell the uncompleted asset to a third party at any point prior to the completion of construction.
- The customer has the right to take control of work-in-progress as construction progresses, for example, through lien rights, title transfer or the ability to take control of the work-in-process if construction is halted at any time. It is important to note that where a customer has the ability to take control of work-in-process if construction is halted, they need not actually exercise this right during the construction process and it may be the case that the seller completes the construction process as agreed.
- The customer has the legal obligation to pay for work-in-process, excluding breach of contract.
- The customer has the right to insure the asset to cover potential loss or damage.

### **Gross profit method versus revenue method**

US GAAP and IFRS provide flexibility in determining a contract's percentage of completion; allowing for input or output models such as cost-to-cost or units of delivery. While output models are preferred, input models are acceptable if output measures cannot be established. However, US GAAP allows for two methods in applying the percentage of completion calculation, whereas IFRS allows only one. US GAAP (SOP 81-1) refers to these methods as alternatives A and B. However, we will refer to them here as the revenue method and the gross profit method.

Under the revenue method, the percentage of completion is applied directly to contract revenues and costs. The difference between actual costs and recognized costs is reported on the balance sheet.

Under the gross profit method, costs incurred are recognized as cost of sales; revenues represent the sum of the costs incurred and the gross profit determined based on the percentage of completion. IFRS does not permit the gross profit method.

The cost-to-cost method is specifically permitted under IFRS and is not impacted by this prohibition. However, contractors that use the gross profit method of units of delivery, milestone, and other methods will be impacted.

### **Combining and segmenting**

The basic concepts underpinning the combination or segmentation of contracts are similar between IFRS and US GAAP. However, under US GAAP, the decision to combine or segment is an accounting policy election, as long as it is consistently applied and reflects the underlying economic substance of a transaction. Under IFRS, when the criteria are met, combining or segmenting is required.

### **Completed contract method**

The completed contract method is not permitted under IFRS. While this method is permitted under US GAAP, it is rarely appropriate because it may be applied only in circumstances where reliable estimates are not available or where results are not materially different from applying the percentage of completion method. Under IFRS, where reliable estimates are not available, except to ensure that no loss will be incurred, revenue is recognized equal to the recoverable costs incurred (zero-profit method). This method is similar to SOP 81-1 where reliable estimates cannot be made, except to ensure that no loss will be incurred.

### **Change orders and claims**

US GAAP and IFRS contain similar principles regarding the accounting for a change in scope of work. Often referred to as change orders under US GAAP and as variations under IFRS, the following general principles should be met before the change order is included in contract revenue: (1) It is probable that the change order will be approved by the customer; and (2) the amount of revenue can be reliably measured. However, with respect to unpriced change orders (or those in which the work to be performed is defined, but the price is not), US GAAP provides additional guidance not explicitly provided under IFRS. Under US GAAP, costs associated with unpriced change orders that are probable of being recovered can be deferred until the parties have agreed on a contract price, or can be recognized in the period incurred and revenue recognized to the extent of such costs. If, however, it is probable that an unpriced change order will result in the contract price being adjusted by an amount that exceeds the costs (that is, a profit is expected on a change order), profit should only be recorded when assured beyond a reasonable doubt. IFRS permits the recognition of change orders provided that it is probable that the customer will approve the change order (and the revenue arising from it) and it is reliably measurable. Therefore, IFRS might be less restrictive than US GAAP when recognizing unpriced change orders, as the threshold for “probable” under IFRS is less than the threshold of “assured beyond a reasonable doubt” under US GAAP. The probability threshold for recognition under IFRS is “more likely than not”, which is considered to be greater than 50 percent, while the “probable” threshold under US GAAP has generally been interpreted to be between 75 and 80 percent.

IFRS and US GAAP have similar criteria for the recognition of a claim. Both standards require that the claim be probable and reliably estimable. However, US GAAP requires a legal basis for the claim, while IFRS requires an advanced stage of negotiations. While both IFRS and US GAAP have a probable criteria for claims recognition, the interpretation of “probable” could vary under each set of accounting standards.

# Inventory

In most respects, the principles of inventory costing and valuation are consistent between US GAAP, and IFRS. However, it is worth noting that IFRS does not allow the use of the last-in-first-out (LIFO) method, although this method is not commonly used by A&D companies because of the prevalence of contract accounting.

Under IFRS, companies must use consistent costing methods (e.g., first-in-first-out or weighted average cost) for all inventories with a similar nature and use. US GAAP is silent on the consistent application of costing methods for inventories with a similar nature and use. For example, some US companies may use different inventory costing methods in different geographies for similar products. This is not permitted under IFRS.

Under US GAAP inventory must be valued at the lower of cost or market (replacement cost), where market cannot exceed net realizable value (NRV) and cannot be less than NRV less a normal profit margin. Under IFRS no such floor or ceiling exists, rather inventory is recorded at the lower of cost or NRV. Also, under US GAAP, once inventory is written down to lower of cost or market, it can not be written back up for subsequent recovery of value. IFRS requires the reversal of inventory write-downs (limited to the amount of the original write-down) for subsequent recoveries.

## Research and development costs

Under US GAAP, non-contractual R&D costs are expensed as they are incurred. IFRS distinguishes between research and development costs. Non-contractual research costs are expensed as incurred and development costs are capitalized as an intangible asset, provided certain criteria are met.

For an organization to capitalize non-contractual development costs under IFRS it must meet the following criteria:

- **Demonstrate the technical feasibility of completing the intangible asset so that it will be available for use** – This criterion should be assessed on an individual project basis. Companies should consider any regulatory approvals, such as FAA certifications, which may be required before the intangible asset will be available for use or sale.
- **Intent to complete the intangible asset and use or sell it** – Management's intention to complete a development project will have to be assessed on an entity and project basis.
- **Be able to use or sell the intangible asset** – A company can demonstrate this criterion if it can use the intellectual property in future production contracts or if it can sell the intellectual property. However, certain intellectual property (e.g., intellectual property used in missiles or fighter aircraft) may have restrictions on its sale or use that should be considered before it is determined that this criterion is met.
- **Demonstrate that the intangible asset will generate probable future economic benefits; show there is a market for the asset; or demonstrate the asset's usefulness if it will be used internally** – As previously discussed, A&D companies typically develop technologies to meet specific needs, and therefore continually assess the potential market for such products. Products normally advance through the various stages of development activity if the companies foresee market potential to support the additional investment. Companies often monitor government spending behaviors in the defense sector before starting any new development project. Accordingly, companies should continually assess the market for either the output of the intangible asset or the intangible asset itself. Companies should assess the usefulness of the asset to determine its recoverable value and whether that recoverable value is in excess of the carrying amount of the asset.



- **Have adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset** – A company can demonstrate the availability of resources to complete, use, and obtain the benefits of an intangible asset by, for example, a business plan showing the technical, financial, and other resources needed and its ability to secure those resources. Organizations should assess this criterion on an individual project basis by reviewing the project plans and considering their viability given the entity's history with such projects.
- **Be able to reliably measure the expenditure attributable to the intangible asset during its development** – Management must have systems that can capture data to distinguish development costs from research and other costs. This criterion should be assessed on an individual project and entity basis as systems for capturing cost data vary in practice.

In addition to development cost capitalization, IFRS also provides a choice of methods for the subsequent measurement of intangible assets. Intangible assets can be carried by using a cost model<sup>1</sup> or a revaluation model<sup>2</sup>. However, to apply the revaluation model, a company needs to determine the fair value of the intangible asset in reference to an active market, which is defined as one where all of the following conditions exist:

- the items traded in the market are homogeneous;
- willing buyers and sellers can normally be found at any time; and
- prices are available to the public.

An active market for intangible assets is rarely available in practice. As a result, we believe companies will apply the cost model in almost all cases.

1 Under the cost model, an intangible asset is subsequently measured at cost less accumulated amortization and accumulated impairment losses.

2 Under the revaluation model, an intangible asset is subsequently measured at its revalued amount, being its fair value at the date of revaluation, less any subsequent accumulated amortization and subsequent accumulated impairment losses. Any remeasurement gains are recorded in equity as revaluation surplus or as an increase in profit or loss if such surplus reverses previously recorded losses on the asset. Remeasurement losses are taken to profit or loss or as a decrease in revaluation surplus to the extent a revaluation surplus exist for such asset.

## Property, plant and equipment

IFRS requires that separate, significant components of an item of property, plant and equipment (PPE) be recorded and depreciated separately. Further, when a component is replaced by a new component, the remaining carrying amount is derecognized. There is no direct guidance on componentization in US GAAP. Instead, under US GAAP, entities use the composite depreciation method in which the cost of a new component is capitalized without derecognizing the replaced component. When converting to IFRS, these companies should determine the impact of changing from a composite depreciation method to a component depreciation method. Such a change may impact both the carrying values of PPE that a company owns at the transition date and how new items of PPE are recorded after the transition. The impact of this change on the carrying values of PPE owned at the transition date will depend on an individual company's facts and circumstances. Companies must take into account several factors, including:

- The significance of PPE to the company's overall financial position
- The average depreciation period currently used under US GAAP
- The remaining useful life of PPE items
- The extent to which the company has experienced significant one-off events, such as business combinations and plant expansions
- The company's current policy for disaggregating various component items of PPE

US GAAP allows three alternatives for major maintenance and overhauls: expense as incurred, capitalize, and the built-in overhaul method. Under IFRS, the costs of major maintenance and overhauls are recognized in the carrying amount of the item of PPE and is depreciated over the period of time until the next major overhaul, provided such costs meet the definition of an asset (i.e., probable of future economic benefits and reliably measurable). Any remaining carrying amount relating to the previous major overhaul is derecognized.

Under both IFRS and US GAAP, routine maintenance costs are expensed as incurred.

## Impact on government contracts

Government contractors must follow the Federal Acquisition Regulation (FAR) and Cost Accounting Standards (CAS). These regulations result in a number of differences from US GAAP, including the allowability of certain costs and the allocation of indirect costs. Therefore, government contractors must maintain reconciliations between their financial reporting and their government cost accounting.

Contractors currently follow a hierarchy that establishes the structure by which they must perform cost accounting. According to this hierarchy, contractors must first follow law (CAS), then regulations (FAR and supplemental regulations), followed by contractual terms and conditions. If none of these provide proper guidance, contractors can look to US GAAP.

Any time a contractor makes a change in cost accounting practices, it must obtain approval from the government. Generally, the contractor is required to complete a cost impact study. Because of the pervasiveness of changes under IFRS, this study may be complex. Furthermore, part 30 of FAR requires that multiple changes may not be offset. Moreover, the government is unlikely to approve changes from which it does not benefit and may not approve any change in accounting principle that does not conform with US GAAP without modification of the current regulations. Therefore, the complexity of record keeping for differences between government cost accounting and financial reporting could increase significantly.

We recommend the industry engage in a dialogue with the government about the nature of IFRS and the need to amend its procurement regulations to minimize the burden on contractors.

## The potential areas of impact for government contractors are summarized in the following sections:

### Direct costs

We do not expect significant differences between US GAAP and IFRS with respect to many direct contract costs. The principles of US GAAP and IFRS are generally consistent in that costs directly attributable to a contract should be charged to the contract.

### Indirect costs

Under IFRS, indirect costs will likely be impacted in two ways. First, the recognition (i.e., the timing) of indirect costs may be affected by differences such as depreciation accounting and stock-based compensation. Second, the allocation of recognized indirect costs (such as home office costs) may be impacted. Currently, a three-factor formula is used to allocate home office costs based on revenue, assets, and employees. Because the adoption of IFRS will likely impact the recognition and measurement of revenue and assets across the entire enterprise, that would result in an impact to the allocation of indirect costs.

### Revenue recognition

As previously discussed, the scope of SOP 81-1 and IAS 11 are not entirely consistent. The contractor must assess whether contracts qualify as construction contracts under IFRS. If the contracts do qualify as construction contracts, the methods used to calculate a contract's percentage of completion (i.e., revenue vs. gross profit method, as previously described) under SOP 81-1 are different than IAS 11. Accordingly, a contractor may need to reconcile its revenue recognition from IFRS to GAAP to perform indirect cost allocations for government contracts.

### Independent research and development

IFRS requires that certain development costs be capitalized, while procurement regulations, in most instances, require such costs be expensed in the period incurred. A reconciliation will be needed between the capitalization of certain development costs under IFRS, as well as the amortization of capitalized development costs to government contract accounting.

## Leases

The FAR currently references Financial Accounting Standard No. 13, Accounting for Leases, (FAS 13), regarding capital leases. FAS 13 is a rules-based standard. Under IFRS, the evaluation of leases is principles based. IFRS considers whether substantially all the risks and rewards of ownership are transferred to the lessee. Contractors that change the classification of a lease under IFRS will need to reconcile expense recognition to FAS 13 for government contracts, unless the FAR is modified to accommodate IFRS.

## Tangible capital assets

IFRS allows certain tangible capital assets to be revalued to fair market value. Contractors that elect to revalue assets under IFRS will need to reverse these effects, including depreciation of the revalued assets, to comply with FAR and CAS.

## Impact on forward pricing

For long-term contracts, the contractor should consider the impact IFRS may have on forward pricing rates. The contractor needs to assess the potential impact of IFRS on the timing of costs and the allocation bases. For example, as previously discussed, the impact of revenue on the three-factor formula must be considered to make sure that forward pricing rates incorporate that impact of changing accounting standards. Failure to do so may result in a contractor improperly pricing amounts and reducing margins or gaining a windfall profit as a result of the change. This may lead to the allegation of defective pricing. We recommend that contractors include a statement in their forward pricing disclosures clearly stating that the pricing excludes the potential impacts of IFRS adoption.

## Potential disallowance of IFRS conversion costs

Because changes resulting from converged standards and IFRS adoption relate to a new accounting standard and are not the result of changes to CAS, the government may disallow conversion costs. Therefore, contractors may not be able to recover all their costs on current contracts because of IFRS transition. Also, from a competitive standpoint, any additional costs resulting from IFRS implementation may result in an inability to recover costs if the inclusion of such costs puts the contractor at a competitive disadvantage from a cost or pricing standpoint.

## Income taxes

The implications of adopting IFRS go well beyond the potential impact on a company's effective tax rate or income tax-related disclosures in a company's financial statements. The move to IFRS has broad tax implications for aerospace and defense companies; potentially impacting global cash tax obligations, international tax planning and underlying systems, processes and controls. The book financial accounting aspects of IFRS have a myriad of tax method accounting considerations. Accordingly, it is essential that tax executives be part of the IFRS transition process. Proper assessment of the tax impact of each potential accounting change not only requires insight into the applicable tax rules and regulations in various tax jurisdictions, but also knowledge of the detailed differences between US GAAP, IFRS, and local statutory accounting, where applicable. In addition to applying differences between the tax standards in IFRS and US GAAP to the accounting for income taxes, a company's tax function will need to understand and analyze each change to book accounting policies and methods in all applicable jurisdictions. There are a significant number of potential differences between IFRS and US GAAP that could materially affect pre-tax accounting income, some of which have been discussed in the preceding sections of this document. In the US, tax methods of accounting do not necessarily follow a company's book method of accounting. As a result, a conversion to IFRS will require an analysis of each new accounting policy for its related tax implications, including a determination as to whether it is permissible or advisable to conform the related tax method of accounting to the new book accounting method. A tax accounting method also frequently does not automatically change because the book accounting method changes. Rather, the company may need to obtain consent of the respective taxing authority. Each jurisdiction may have a different process to obtain such consent and address the transition effects in various ways. For example in the US, a tax liability arising from a change in accounting method can often be paid over four years.

Certain other jurisdictions, with increasing frequency, measure a company's taxable profits mainly in accordance with its financial accounts and permit or require adoption of IFRS at the legal entity level. In such cases, the adoption of IFRS will likely have a direct impact on a company's cash tax position and more attention will need to be focused on the cash tax implications of the various financial accounting policy decisions made during the conversion to IFRS.

For US A&D companies, systems, processes, and controls used within the tax department have been primarily designed to deliver information to meet the financial statement reporting requirements of US GAAP, along with various tax compliance and reporting requirements. Recent developments in tax and financial reporting have increased the importance of these systems and processes. Companies have sought to automate and enhance their tax processes to reduce risk and increase efficiency. A change in the underlying basis of accounting to IFRS will require tax departments to perform a review of their systems and processes for gathering tax-related data. Systems and processes that have been used to track or compute

book-tax differences, record the tax treatment of stock-based compensation, or calculate the tax provision will need to change. Transfer pricing documentation, as well as agreements with tax authorities and tax rulings that may have been based on US GAAP or local statutory accounting, may need to be recast onto an IFRS basis.

The adoption of IFRS by tax jurisdictions and IFRS as a common accounting language throughout the enterprise may also provide opportunities for increased efficiencies in the tax function. Tax departments may no longer have to reconcile many different statutory accounts to the financial accounts and other tasks may be addressed more centrally.

Although the US GAAP and IFRS frameworks share many fundamental principles such as a balance sheet approach, they are at times interpreted and applied in a different manner. The following represent some of the more significant differences between the two standards, taking into consideration the proposal by the IASB for a replacement of IAS 12, Income Taxes:

- **Uncertain tax positions:** The IASB is expected to require a probability-weighted average approach to recognize and measure uncertain tax positions without considering a recognition threshold. This will likely lead to an increased level of effort under IFRS than the current FIN 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109, processes, as all possible outcomes have to be identified and likely more positions will need to be assessed. However, disclosure requirements are expected to be generally less onerous under IFRS for uncertain tax positions.
- **Unrealized intragroup profits:** Under US GAAP, any income tax effects resulting from intragroup profits are deferred by the seller and recognized upon sale to a third party or depreciation/amortization of the transferred asset. IFRS requires the recognition of the seller's tax consequences and the recording of deferred taxes based on the buyer's tax rate at the time of the initial transaction. The net effect of recognizing the seller's tax consequence and the buyer's deferred tax asset requires multinational entities to consider the location of their cross-border inventories at the balance sheet date because the location of the inventory could result in a significant impact to recorded tax assets. For enterprises with significant fluctuations in inventory levels between periods or significant property transfers, this difference could also affect the effective tax rate.
- **Non-monetary assets:** For subsidiaries with a functional currency different than the local currency, the relevant book basis of non-monetary assets is determined at historical exchange rates. IFRS requires the recognition of deferred taxes on the difference arising between the local currency tax basis and the book basis at historical exchange rates, even though such difference is not affecting pre-tax income. US GAAP prohibits the recognition of such deferred taxes and accordingly the conversion to IFRS will result in additional volatility in the effective tax rate.

## Other considerations

The preceding issues represent some common issues that contractors should consider, but it is not an all-inclusive list. Contractors will need to carefully consider the impact of all accounting changes on government contracting. They should obtain the proper knowledge and assistance to assess the impacts of IFRS on their business and what the transition may mean in terms of government contract compliance, costing, and pricing.



## Future considerations - IASB and FASB Joint Revenue Recognition project

In December 2008, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) jointly published the discussion paper Preliminary Views on Revenue Recognition in Contracts with Customers. The paper details the boards' preliminary views on a new revenue recognition model that, if adopted, would replace the current guidance under both IFRS (including IAS 11) and US GAAP (including SOP 81-1). Under the proposed model, revenue would be recognized only upon the satisfaction of performance obligations, which occurs when the customer controls the asset. Accordingly, the current percentage of completion revenue recognition method used by many A&D companies could be significantly impacted.

Another anticipated difference relates to accounting for contract costs. The discussion paper indicates that the boards do not intend to include accounting for costs in the new guidance on revenue recognition. Therefore, costs would qualify for capitalization only if they meet the criteria of another standard (such as IAS 2, Inventories; IAS 16, Property, Plant and Equipment; or IAS 38, Intangible Assets). Accordingly, certain costs currently recorded as contracts in progress may not qualify for capitalization. Both boards expect to issue a final standard in 2011. Comments on the discussion paper were due by June 19, 2009. The full discussion paper and comment letters can be found at [www.IASB.org](http://www.IASB.org) or [www.FASB.org](http://www.FASB.org).

The information contained above in this paper deals with IFRS standards as of July 31, 2009 and does not address the potential changes from the current revenue recognition project.

What this means for your business  
Staying focused on aspects of convergence  
and adoption that have a long lead-time.

The best way to manage the quality, benefits, and overall cost of IFRS projects is to actively manage the process. Independent of when the United States ultimately adopts IFRS, those standards are already having a significant impact on US businesses. The impact will only increase in the next several years as convergence takes place and eventual adoption of IFRS draws closer.

In the near term, four main challenges require A&D companies' attention on the IFRS front:

- Keeping pace with an unprecedented rate of financial reporting change as converged standards roll out in roughly a dozen key areas between now and the end of 2011
- Monitoring and managing subsidiaries' adoption of IFRS as more countries move to IFRS
- Understanding the ways in which the structure of deals and transactions with non-US counterparties (particularly vendors and customers) may be influenced by those counterparties' increased interest in IFRS accounting outcomes
- Continued focus on longer lead-time differences between IFRS and US GAAP, since convergence projects will not eliminate all current differences between the two sets of standards

To successfully face these challenges, companies should:

- Assess the potential impact of convergence and, ultimately, of IFRS adoption:
  - Contemplate using scenario planning to help incorporate likely convergence and IFRS adoption outcomes into strategic thinking and business planning.
  - Assess how the changes will affect the company's reporting, long-term contractual commitments, tax structures, financing, systems, and controls.
  - Consider how the actual accounting changes will influence customers and vendors
- Oversee subsidiary adoption of IFRS: Closely monitor non-US subsidiaries' accounting policy elections as they adopt IFRS. Influence subsidiaries' transition timing and strategies.

By staying focused on aspects of convergence and adoption that have a long lead-time, companies can stay ahead of the game, while also pursuing small one-off projects and "easy wins" where desirable.

To have a deeper conversation about how  
this subject may affect your business,

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