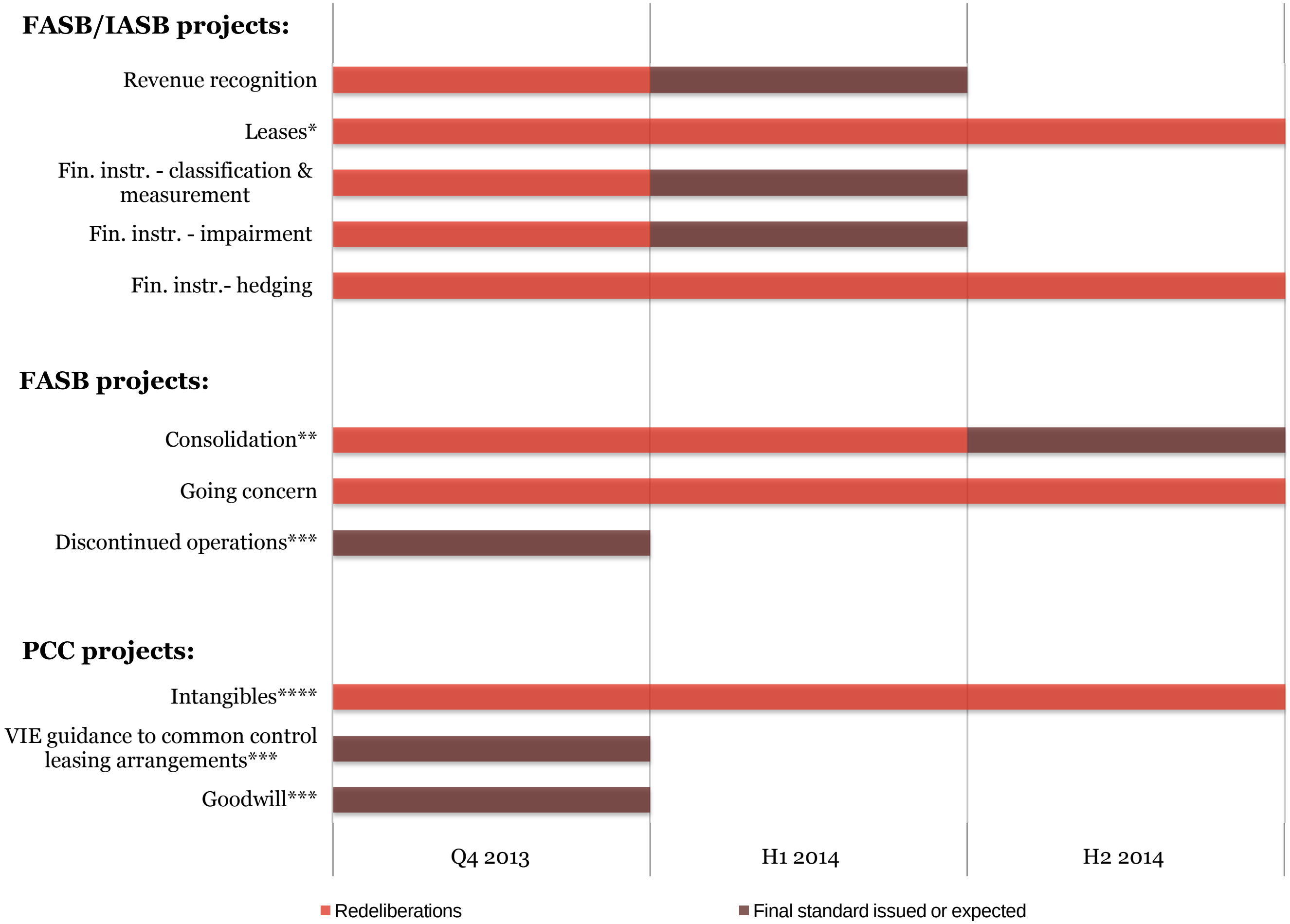
Engineering and construction industry – Constructing change: A standard-setting roadmap

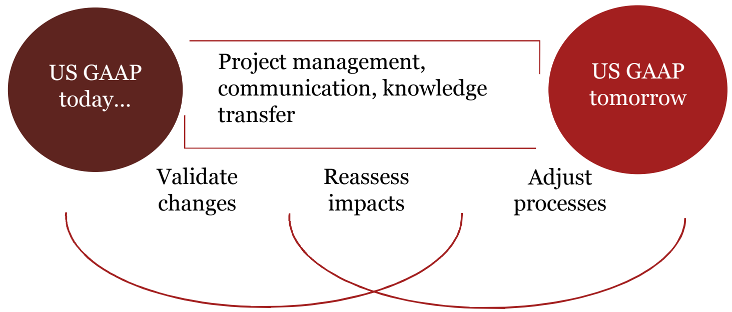
Timeline of activity expected to drive significant change in the engineering and construction industry - as of November 15, 2013:



Overarching impact on E&C companies

The boards' projects cover major components of the financial statements and are intended to improve financial reporting information for investors. The changes expected to result will reach beyond financial reporting, impacting entity-wide functions, key financial statement metrics, and legal contracts. Companies should gather necessary data and analyze the implications of these projects given the significant business and operational implications. Companies may need to take actions that include revising existing or implementing new IT systems, changing contractual terms, and revising their business strategy in response to these projects. The movement from today's financial reporting to the financial reporting of the future will require project management, communication, and transfer of knowledge throughout the organization as companies navigate the change.

Navigating change



*The comment period ended in September 2013 with over 600 comment letters submitted. Redeliberations are expected to begin in December, and a final standard is not likely to be issued until late 2014 at the earliest.

**Given the status of discussions a final standard is not likely to be issued until sometime in H2 2014.

***Given the status of discussions, issuance of the final standard could be delayed to 2014.

****Given the status of discussions, the timing of a final standard is undetermined.

Summary of priority projects and their key impacts based upon current redeliberation decisions

Revenue recognition

The proposal establishes accounting principles for revenue arising from customer contracts and includes a five-step process to apply:

- Identify the contract with the customer
- Identify the separate performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to separate performance obligations
- Recognize revenue when (or as) a performance obligation is satisfied

Key impacts

- **Performance obligations:** Increased number of revenue-generating deliverables (referred to as "performance obligations")
- **Contract modifications:** Combine with original contract unless it is a separate performance obligation and priced commensurate with the underlying good or service (no discount or premium)
- **Variable consideration:** Recognize revenue as performance obligations are satisfied only if it is probable that there will not be a significant reversal in the future
- **Time value of money:** Account for time value of money when the period between transfer of the promised goods or services and payment is greater than one year
- **Collectibility:** Recognize revenue when collectibility is probable. Initial and subsequent impairment of receivables will be presented separately as an expense below gross margin
- **Use of allocation methods:** Required to allocate based on standalone selling price. Residual techniques might be used in certain circumstances to estimate selling price
- **Revenue recognition:** Recognized when control transfers to the customer, which may be over time or at a point in time
- **Warranties:** Follow cost accrual model for quality assurance warranties and deferral of revenue model for service warranties. If an arrangement contains both quality assurance and service components and are unable to bifurcate, account for the entire arrangement as a service warranty
- **Contract costs:** Costs of fulfilling a contract are capitalized, if not within the scope of other standards, and are direct contract costs, relate to future performance, and are expected to be recovered. Incremental direct costs of obtaining a contract are recognized as an asset if expected to be recovered
- **Disclosure:** Requires more extensive disclosure than required under today's GAAP
- **Transition:** "Full" retrospective or simplified (current and prospective) transition methods allowed
- **Effective date:** The standard will be effective for 2017 reporting periods for calendar year companies. Early application will not be permitted

Leases

The proposal significantly changes lease accounting, as it will:

- Require lessees to recognize a "right-of-use" asset and corresponding lease liability for the obligation to pay rentals for substantially **all** leases
- Measure the lessee's right-of-use asset and lease liability based on the present value of future lease payments
- Change income and expense recognition dependent on whether a lessee acquires or "consumes" more than an insignificant portion of the underlying asset. Straight-line expense recognition for most property leases and front-loaded expense recognition for most leases other than property
- Change lessor accounting depending on whether the lease gives a right to acquire or "consume" more than an insignificant portion of the underlying asset. Underlying asset remains on the balance sheet and income recognized on a straight-line basis for most property leases. "Receivable and residual" approach, derecognizing the underlying asset and replacing it with a lease receivable and a residual asset, for most leases other than property
- Require separation of lease and non-lease components

Key impacts

- **Elimination of operating lease accounting:** All leases recorded on the balance sheet, except short-term leases, which would be treated as operating leases if accounting policy election made
- **Impact on key metrics:** Capital and leverage ratios will change, front-load of expense depending on type of lease, change in P&L geography of expense, and an increase in EBITDA
- **Variable consideration:** Excluded from the measurement of the right of use asset and lease liability (unless variable lease payments are in-substance fixed lease payments)
- **Lease term:** Include options when the lessee has a significant economic incentive
- **Federal government contracts:** Interest is typically not a reimbursable cost
- **Impairment:** When and how to test for impairment of the "right-of-use" asset or lease receivable
- **Taxes:** Possible impact on book-tax differences (e.g., change in depreciation expense may impact deferred tax liability)
- **Presentation and disclosure:** Requires more extensive disclosure than required under today's GAAP
- **Transition:** "Full" or "modified" retrospective application required

Financial instruments

The proposal addresses three elements of financial instrument accounting:

- Classification and measurement – targeted changes to how financial instruments will be measured
- Credit impairment – proposals intended to address concerns of delayed recognition of impairment and overstating interest income
- Hedge accounting – simplifies ability to obtain hedge accounting treatment, but requires measurement of ineffectiveness

Key impacts

- **Equity investments:** Fair value through net income (FV-NI), for all equity securities (but practicability exception option for non-marketable securities)
- **Available-for-sale debt investments:** Fair value through other comprehensive income (FV-OCI) category is retained but with defined criteria based on business strategy and instrument characteristics
- **Held-to-maturity debt securities:** Amortized cost is retained but with defined criteria based on business strategy and instrument characteristics
- **Loans held-for-investment:** Continue to be classified and measured at amortized cost if criteria based on business strategy and instruments characteristics are met
- **Reclassification:** Prospective reclassifications between categories permitted when there is a significant change in business strategy, but expected to be very infrequent
- **Credit impairment:** Reserves no longer based on incurred basis; FASB's "current expected credit losses model" would increase reserves based on lifetime of expected losses

Next steps

- **Classification and measurement:** The Boards are redeliberating their respective models jointly
- **Impairment:** Redeliberations are expected to continue; however, it is unclear how the boards will proceed with the differences between the IASB's "credit deterioration model" and the FASB's "current expected credit losses model"
- **Hedging:** The FASB plans to revisit hedge accounting after the classification and measurement and impairment elements of the project are complete