



June 19, 2009

Financial Accounting Standards Board

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Attn: Technical Director – File Reference No. 1660-100
(Via U.S. Mail and Electronic Mail)

Re: CFMA’s Comments on the FASB and IASB’s Preliminary Views on Revenue Recognition in Contracts with Customers (File Reference No. 1660-100)

CFMA is pleased to provide our response to the FASB and IASB’s Preliminary Views on Revenue Recognition in Contracts with Customers (hereafter, “Discussion Paper”). Founded in 1981, CFMA has 88 chapters across the U.S. and more than 7,000 members. Private companies employ many of these members. CFMA General Members are CFOs, treasurers, controllers, accountants, financial managers, and those with a financial responsibility for their companies. Associate Members include bankers, insurance and surety agents, attorneys, CPAs in public practice, and others who serve the construction industry.

CFMA represents the professionals who specialize in financial reporting within the construction industry; as such, CFMA is particularly qualified to supply the FASB and IASB with feedback as they work to establish accounting standards that impact construction contractors.

Our response is formatted to comprehensively address the FASB and IASB’s efforts to improve financial reporting with respect to revenue recognition. However, this is not limited to the questions included in the Discussion Paper. As a result, we will comment expansively on the perceived strengths and weaknesses of the Discussion Paper in order to provide the appropriate feedback on the impact of the proposed changes to revenue recognition as it relates to the construction industry.

After we provide our comprehensive comments, we will then address the questions presented in the Discussion Paper that are relevant to our constituency.

Efforts to improve financial reporting/revenue recognition rules

We applaud the FASB on its effort to improve financial reporting with respect to revenue recognition. CFMA appreciates that there is: tremendous divergence in practice that can vary by industry; numerous rules that can sometimes present conflicting guidance; gaps in current literature; and a need for clearer principles that can broadly apply to numerous industries in order to achieve more consistent outcomes. We also fully support efforts to achieve convergence with international standards, as long as the quality and integrity of existing and proposed U.S. construction accounting rules are maintained in concept.

Applicability of a broad standard on contracts with customers to the construction industry

We acknowledge the usefulness of efforts to adopt a single and consistent principle-based standard across numerous industries. However, we believe the proposed standard overlooks many unique and significant

aspects of revenue recognition for the construction industry and will create needless complexity when applying certain provisions of the Discussion Paper.

It is important to begin with an appreciation for the complex and dynamic environment that a contractor operates within, and to understand how that environment significantly differs from fairly simple and straightforward customer transactions.

It is not uncommon for all of the following to be present in a single multi-million dollar construction project:

- A contractor who has also functioned as the designer via a design/build contract, therefore assuming certain additional obligations for completed operations and resulting implied warranties.
- Financial incentives for early completion, perhaps on a sliding scale – and perhaps to be apportioned to various parties to the contract based upon a scale.
- Substantial penalties for delays in completion, usually in the form of liquidated damages.
- Numerous change orders – some are “priced,” but many are “unpriced” for long periods.
- Dozens of subcontractors who assume various performance obligations of the prime or general contractor; however, the prime contractor maintains full recourse for his/her work. In the case of subcontractor default, the prime contractor may be responsible for completing the work (via a replacement subcontractor) at substantial additional costs.
- Owner allowances for options or additions to the contract with no additional compensation to the contractor.
- Claims by the prime contractor for interference by the owner, including work stoppages due to owner-imposed delays.
- Contract provisions that cap or limit the total change order reimbursement to the contractor.
- Contract provisions or memoranda that limit owner access to the site during certain periods of the construction process.
- Price escalation clauses for commodity price changes.
- A contractor who may be required to purchase land on behalf of an owner, and/or to finance a significant portion of the contract value for an extended period of time (e.g., 6-12 months from completion).

The Discussion Paper currently addresses simple and relatively static contracts with customers, with a presumption that separate performance obligations can be easily identified and assigned an estimated transaction price without an undue burden. However, the reality of the construction environment (as demonstrated above) is much more complex and dynamic than presented in the Discussion Paper. In order to address these common yet complex aspects of the construction industry, substantial additional interpretive guidance is necessary for the preliminary views presented in the Discussion Paper to be operational in practice.

S3 of the Discussion Paper indicates that, “The Boards are developing (a) model to improve financial reporting by providing clearer guidance on when an entity should recognize revenue...as a result, the Boards expect that entities will recognize revenue more consistently for similar contracts.”

Similarly, 1.6 of the Discussion Paper states that, “The fact that entities apply the earnings process approach differently to economically similar transactions calls into question the usefulness of that approach.” Finally, 1.20 of the Discussion Paper reads, “Users of financial statements should benefit because economically similar transactions would be reported similarly.”

As we continue to address our concerns regarding the preliminary views presented in the Discussion Paper, we encourage FASB to keep the above statements in mind, as *CFMA believes the proposed guidance will actually result in greater inconsistency in revenue recognition compared to current practices for the construction industry.*

Specifically, we believe that a group of reasonably informed businesspeople could take the facts cited in the bulleted list of examples on page 2, and each person would come up with distinct interpretations of the:

- Identification Performance Obligations of the Contract
- Satisfaction of Performance Obligations/Customer Control – and when a change of control takes place
- Measurement of Performance Obligations
- Measurement of Transaction Price
- Methods for Allocation of the Transaction Price to Separate Performance Obligations
- Determining when, whether, and how to Re-measure Performance Obligations

So, while FASB seeks to implement a standard that will result in greater consistency in revenue recognition, at this point we believe the views presented in the Discussion Paper do not achieve that goal for the construction industry, as each contract is unique and guided by customer specifications. In fact, the guidance needed to help ensure consistent treatment under the planned approach is substantial and potentially complex.

To further illustrate, consider the process prescribed for estimating Standalone Selling Prices (even under the simplest methods allowed). It would be very unlikely that two reasonably informed businesspeople would come up with consistent answers for the remaining Performance Obligation (assuming all Performance Obligations could be consistently identified) and when control has transferred. Moreover, the process prescribed for measuring Standalone Selling Prices in the complex reality of the construction industry would be unduly burdensome and particularly difficult to defend in light of the requirement to maximize observable inputs.

As noted above, one stated goal of the Discussion Paper is that users of financial statements should benefit because economically similar transactions will be reported in the same manner. However, under the guidance prescribed in this document, it is likely – due to slightly different contract terms – that a contractor will report revenues differently from two economically similar projects. This will lead to greater confusion among financial statement users who will likely require significant additional supplementary disclosure and communication so they can understand which projects are receiving incremental revenue recognition and which projects are deferring revenue recognition. Moreover, it is likely that they will want contractors to provide schedules that calculate the actual value and estimated gross profit of construction put in place during the year by the contractor.

Other challenges presented by the preliminary views compared to existing practice

Beyond the challenges to achieving consistency, re-measurement provisions appear to require additional consideration for the construction industry. The Discussion Paper indicates in 5.39 and 5.56 that “changes are not significant in most contracts.” *Yet, contract changes are an everyday operating reality for construction contractors.* It also seems that the process prescribed for re-measurement is needlessly burdensome and complex, compared to the Cumulative Catch-up Method used in current practice. The standard would also require cost guidance and an amendment for asset standards to address how to account for contract-specific costs incurred. (Note: The benefit of the Cumulative Catch-up Method is that a contract’s net position is re-measured as soon as change becomes known and quantified, and a

consistent gross profit is re-established for a period both before and after the change is identified and measured.)

As currently drafted, the preliminary views on identifying Performance Obligations, when a change in control has taken place, estimating Standalone Selling Prices, and re-measuring Performance Obligations will present tremendous challenges for external auditors, which will in turn increase compliance costs for contractors compared to current practice.

It appears that because of the difficulty in re-measurement using the approach(es) presented in the Discussion Paper, the FASB reached a conclusion that re-measurement should only occur when a performance obligation is deemed onerous. However, under existing practice, re-measurement at each annual and interim reporting period is a relatively simple process for most contractors, and an integral component of the operation of each individual contract. CFMA strongly encourages simplification to the re-measurement process and permitting re-measurement for positive or negative changes in contract position at each reporting date.

Due to the unique nature of the construction industry, contractors typically incur substantial up-front costs related to the procurement of construction contracts. Those costs can include: bid bonds; plans and specifications; engineering take-offs and architect/engineer fees; and contract-specific costs. Such costs represent a viable asset to the successful bidder on the contract, since the contractor has incurred substantial up-front costs that will mitigate costs in the future and are expected to be recovered in the contractor's proposed contract revenue during the bidding phase. Existing practice allows contractors to capitalize such preconstruction costs once they have been awarded the contract.

CFMA encourages the FASB to continue to permit the capitalization of such costs, as these costs are believed to meet the definition of an asset as defined in FASB Concept Statement No. 6.

Current Accounting Guidance

The following section contrasts the challenges (as noted above) with the current guidance provided by AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts (SOP 81-1)*.

While there are limitations to SOP 81-1, this standard has served the construction industry well for more than 25 years. Moreover, the standards presented in SOP 81-1 work tremendously well at taking complex real-world issues (such as the bulleted list of examples on page 2) and provide clear, simple, and easy-to-understand guidance on how to recognize revenue. The result is that current practice already yields a very high level of consistency in financial reporting of similar transactions.

In fact, these provisions allow for two reasonable people to use the same set of facts and reach a very comparable conclusion. These conclusions are easy to replicate, easy to defend, and relatively easy to audit.

In short, SOP 81-1 already provides for the construction industry what the FASB intends to accomplish for other industries with the current Discussion Paper. The FASB should consider these industry-specific concerns and expand the guidance with the revenue recognition exposure draft to clarify how revenue should be recognized on long-term contracts with differing characteristics and performance obligations.

CFMA feels strongly that any significant departure from the tenets of SOP 81-1 will: lead to information that is less decision-useful and result in less consistency; be more complex and costly to administer; lead to higher audit costs; and create a need to re-educate financial statement users, such as bankers and sureties who already have a thorough grasp on the revenue recognition approach contained in SOP 81-1.

However, the convergence with International Accounting Standard 11, *Construction Contracts* (IAS 11) would be beneficial. Further clarification of control transfer and related measurement should not only expand the Discussion Paper guidance as it relates to our industry in the exposure draft, but should also consider the many contract types used in the construction industry today.

Even though CFMA agrees that SOP 81-1 would benefit from a modernization effort to catch up with some of the advancement that has occurred within the construction industry, we do not believe that it should be completely replaced by a brand new set of standards.

Examples of useful areas SOP 81-1 that need updates and revisions include:

- 1) The contract types addressed in SOP 81-1 do not consider cost plus not to exceed contracts (guaranteed maximum price contracts), design/build construction contracts, or construction management at risk contracts – as well as how to account for them – since these types of contracts were not prevalent in 1981.
- 2) SOP 81-1 does not specifically address how to account for contract allowances for customer-specified items, including how to recognize the related revenue, when to recognize cost and profit, and whether this should even be included in total estimated revenues and costs, since this is a customer-specified item that is acquired at their direction.
- 3) SOP 81-1 also does not specifically address when to recognize revenue on significant material purchases in the initial phases of a contract when installation takes place at a later date, and does not specifically address whether customer-specified materials differ in treatment from purchases at the convenience of the contractor, including how title transfer to the customer impacts revenue recognition.
- 4) Certain major contracts require bond premiums to be paid at the beginning of a multiple year contract, which is billed to the owner – even though the bond is in force throughout the contract. Guidance should be added to indicate whether revenue and profit should be recognized up front, or if the cost should be amortized over the life of the contract.
- 5) Additional guidance is needed to specify how a contractor should recognize warranty accruals or obligations. It should address whether this is an accrual, which delays final revenue recognition until the end of the warranty period; or, whether this is an accrual of cost, which is treated separately from the contract upon completion.
- 6) Existing guidance does not address costs incurred on contracts that have been awarded but, due to unforeseen conditions, which the contractor is uncertain if the contract will continue or that a notice to proceed will be issued. This has become much more prevalent in the current economic environment.
- 7) SOP 81-1 has subjective guidance in ¶.61-.63 for unapproved change orders and in ¶.65-.67 relating to claims. The guidance should be more specific to provide consistency among contractors. Also, it does not indicate when to specifically recognize incentives or penalties within a contract. This should be clarified to provide consistency.
- 8) The industry has standard contracts (1997 & 2007 AIA Contract Documents and ConsensusDOCS), which include clauses where the owner can terminate a contract at his/her convenience. Authoritative guidance should address how this clause should impact revenue recognition and related costs associated with a termination.
- 9) Further clarification is needed to specify how and when to either combine or segment contracts under ¶.35-.42 of SOP 81-1. In addition, how the loss on one contract impacts the profit on a related contract must be addressed.
- 10) Due to the changes in the current economic environment, guidance is needed to determine the amount of contract revenue to recognize on certain contracts that have alternative means of financing and

payment. This is becoming more prevalent in the construction of government projects – especially schools, government office buildings, and such large projects as utility plants.

There are several income tax provisions that offer credits for “energy efficient” buildings. One of the largest is the \$1.80 per square foot tax credit for a building when the lighting, HVAC, and building envelope are all certified at least 50% more energy efficient than a comparable building. The IRS has issued guidelines that allow a non-taxable entity to pass the credit on to the designer, which in some cases can be the contractor.

Example:

City of Gotham is going to build a new courthouse. The project will be a 200,000 square foot energy efficient facility, at an estimated cost of \$6M. The City has stated that it will issue the contract for \$5.6M, and in addition, will pass the \$360,000 energy tax credit back to the designer-contractor. Does the contractor show the total contract price on his financial statements at \$6M or \$5.6M? What if the contractor is not able to use the tax credits before they expire? If he records the contract on the financials at \$6M, does it stay open until the credit expiration period has passed?

Responses to Discussion Paper Questions

Chapter 2, Question 1

Do you agree with the Boards’ proposal to base a single revenue recognition principle on changes in an entity’s contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

CFMA: The concept of determining a net contract asset or liability as introduced in 2.23 is not dissimilar to the percentage-of-completion method (PCM) currently in SOP 81-1; however, as previously noted, we do not believe that there should be significant departures from SOP 81-1 for the construction industry.

Chapter 2, Question 3

Do you agree with the Boards’ definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

CFMA: According to standards in the construction industry and SOP 81-1 ¶.12, we do not agree that the definition of a contract as presented in 2.11 of the Discussion Paper is complete. The definition of a contract must include change orders and must address amendments and/or adjustments to the original contract or a new contract.

Chapter 3, Question 4

Do you think the Boards’ proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

CFMA: We do not believe that the Boards’ proposed definition of a performance obligation, in and of itself, provides sufficient guidance for determining deliverables/components of a contract and when control has transferred. If the construction industry is to be covered by the views presented in the Discussion Paper, then substantial additional guidance will be needed to aid in the identification of performance obligations, when control is transferred, and the related measurement of revenue. The example previously provided should be referred to when developing this guidance.

Chapter 3, Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

CFMA: Generally, yes. However, specific to the construction industry, we believe that the provisions of SOP 81-1 ¶.22 should be followed in determining the transfer of promised assets. This position appears to be supported by 6.20 of the Discussion Paper.

Chapter 4, Question 8

Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

CFMA: As previously noted, we believe that the provisions of SOP 81-1 ¶.22 should be retained, or the level of guidance should be expanded to consider the types of contracts used today and expand cost guidance to account for performance obligations.

Chapter 4, Question 9

The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

CFMA: According to 4.5 of the Discussion Paper, physical possession is an indicator of control and would therefore tend to defer revenue recognition. In construction, physical possession by the customer is not practical. Again, we believe that SOP 81-1 ¶.22 provides the appropriate guidance for the construction industry. This should be incorporated into the exposure draft.

Chapter 5, Question 10

In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

- (a) *Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?*

CFMA: Yes.

- (b) *Do you agree that a performance obligation should be deemed onerous and re-measured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?*

CFMA: Yes, but re-measurement should not be limited to only these circumstances, guidance should be expanded, and consideration given to the bulleted items on page 2.

- (c) *Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.*

CFMA: Yes, as noted in our comments above regarding re-measurement.

- (d) *Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.*

CFMA: Yes, as noted in our comments above regarding re-measurement.

Chapter 5, Question 11

The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.

- (a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?*
- (b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.*

These questions are substantively addressed by our prior comments on preconstruction costs.

Chapter 5, Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

CFMA: For the construction industry, we strongly prefer the continuation of measuring revenue according to the percentage-of-completion method (PCM), which is typically performed using a cost-to-cost approach. Such approach obviates the need for the allocation as noted above; however, if these views were to apply to the construction industry, we would advocate that the allocation to the performance obligation be based upon estimated relative costs not estimated selling prices. For a construction contract, estimated selling prices of goods or services underlying performance obligations seems to be an arbitrary concept that lacks economic substance. Current guidance under ¶.22 of SOP 81-1 should be incorporated into the exposure draft to clarify how the construction industry should determine revenue.

Chapter 5, Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

CFMA: Please see previous comments.

Conclusion

CFMA sincerely appreciates the opportunity to share these views as the FASB and IASB deliberate this extremely important project. We welcome further dialogue with the FASB and IASB to clarify any of our comments presented here.

We respect the FASB and IASB's commitment to providing high-quality, operational financial reporting standards for financial statement issuers and users. The due process afforded to those, such as CFMA, wishing to comment on standards affecting our constituency is an important and valuable part of this process. Again, we are grateful for your efforts and would be happy to meet with the FASB and IASB to further discuss these concerns.

If there are questions regarding our position, please contact Peter Schwartz, CFMA's President and CEO/Co-Chair, Emerging Issues Subcommittee, at (609) 452-8000 or pschwartz@cfma.org.

Respectfully submitted,

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