CFMA
CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION
The Source & Resource for Construction Financial Excellence

January 30, 2013

Mr. Robert Durak
AICPA
1211 Avenue of the Americas; 19th Floor
New York, NY 10036

Via e-mail

Re: Proposed Financial Reporting Framework for Small- and Medium-Sized Entities

Dear Mr. Durak:

The Construction Financial Management Association (CFMA) is "The Source & Resource for Construction Financial Professionals" and the only nonprofit organization dedicated to serving the construction financial professional. Headquartered in Princeton, NJ, CFMA currently has more than 6,500 members in 89 chapters throughout the U.S. and Canada.

Established in 1981, CFMA's General Members represent all types of contractors, as well as developers, construction managers, architects, engineers, principals, and material and equipment suppliers. Associate Members include the accounting, insurance, surety, software, legal, and banking specialists who serve the construction industry.

CFMA undertook a broad, deliberative process to formulate comments on this Exposure Draft (ED), seeking input both within and outside of its membership. To that end, CFMA invited the National Association of Surety Bond Producers (NASBP), a national trade organization of firms employing licensed surety bond producers, to establish a liaison with our committee formulating comments and share the perspectives of bond producers who comprise a significant set of consumers and end users of construction company financial data. NASBP's perspectives and input are represented within our written comments. Questions of NASBP may be directed to Mark H. McCallum, CEO, 1140 19th Street, NW, Suite 800, Washington, DC 20036.

CFMA wishes to acknowledge its appreciation to NASBP, and especially to its liaison representative, Darrin Weber, CPA, CIC, of IMA, Inc., Dallas, TX, for assistance with these comments. Further, NASBP coordinated a survey of its members and surety bond underwriters which we believe provides important insights into AICPA's proposed framework. The results of this survey are referenced within this letter.

CFMA has been a highly active member of the standard setting community for many years, particularly during the last five years in response to the profound impact that many of the recent proposed standards will have on the engineering and construction industry. Throughout this period, we have remained engaged in the progression of certain standards, sought to understand the standard setters' objectives, and provide well-reasoned and thoughtful feedback after extensive outreach, not just with our own members, but with other members of the engineering and construction industry.

A few examples of CFMA's activities include:

- Participation in public roundtables;
- Conducting numerous educational Webinars (both with and without direct involvement by representatives of standard-setting bodies);
- CFMA member-led Webinars/audiocasts for both Associated Builders & Contractors of America, Inc. (ABC) and NASBP;
- Presentations at national conferences; and
- Submission of comment letters on all significant proposed standards of the last five years.

CFMA is pleased to take this opportunity to comment on AICPA's Proposed Financial Reporting Framework for Small- and Medium-Sized Entities (Proposed Framework).

In general, we agree with the concept of having a separate financial reporting framework for small- and medium sized entities. We believe, if appropriately conceived and maintained, that such a framework could provide benefits for certain stakeholders that are equal to, or greater than, current generally accepted accounting principles.

However, we do have concerns regarding the development and intended maintenance of this framework which we believe must be addressed for it to have the greatest opportunity for success.

We wish to frame our comments within two categories: 1) those broad considerations that we consider vital in ensuring that such a framework achieves the objectives outlined by AICPA, and 2) certain targeted considerations aimed at those technical areas that are unique to the engineering and construction industry (specifically the application of the percentage-of-completion method (PoC) and related guidance).

Broad Considerations

Timing

AICPA issued this ED on November 1, 2012, requesting comments on the holistic framework by January 30, 2013 (90 days). Standard-setting, by its very nature, is an iterative process, requiring a well-thought out and oftentimes extended timeline such that constituents and standard-setters alike have sufficient time to ensure that any standard meets the fundamental objective of providing high quality financial reporting to key stakeholders. History has proven that many standards, specific to even just one topic, necessarily take years to issue and even longer to effectively educate constituents and implement. For example, both the United Kingdom's Financial Reporting Standard for Smaller Entities and the IFRS for Small- and Medium-Sized entities as issued by the IASB took many years to complete. In general, we believe that the more common approach to standard-setting undertaken by FASB (a cadence of discussion paper to exposure draft to final standard, with robust constituent outreach between each phase) is appropriate.

When viewing the proposed ED through this lens, and further taking into account that this ED relates not to just one or a few standards, but rather a framework as a whole, we are very concerned that AICPA has not afforded constituents, or itself, the appropriate time to engage in outreach or otherwise provide commentary on the Proposed Framework. We recommend a more measured approach whereby the framework is "broken down" into tactical phases (including a phase related to the "companion volume" which we understand is not being made available for public comment), whereby constituents are permitted to comment on these phases progressively.

We fully acknowledge that such an approach may take months, if not years, to complete, yet we believe such a measured approach will ensure that AICPA and constituents alike have enough time to ensure that this framework meets its stated objectives in full and provides a framework of high quality standards providing decision-useful information to key stakeholders.

Transparency

We believe that any standard-setting project should be sufficiently transparent such that the interested public at-large understands the means by which the standard-setter came to its conclusions. While we acknowledge, and indeed applaud, AICPA's efforts and leading voice in the historical debate over private company financial reporting including, but not limited to, its involvement with the Blue Ribbon Panel and the Private Company Financial Reporting Taskforce, it is unclear to us the means by which conclusions (including those related to cost/benefit) on this Proposed Framework were reached.

We encourage AICPA to make committee meeting minutes and other relevant information publically available, ensuring that the process is sufficiently transparent and can be studied. We further encourage AICPA to make publically available deliberations and/or meeting minutes regarding future changes to this Proposed Framework.

Moreover, much of the tension which existed for years between FASB and private company financial reporting stakeholders concerned of the lack of due process in setting GAAP impacting private companies. As the Proposed Framework is one plank in the platform for helping to improve financial reporting for private companies, it is vital that these efforts be fully transparent and deliberative to ensure appropriate due process.

Further, given the development of the Private Company Council (and AICPA's recent endorsement of this council), we encourage AICPA to closely collaborate with the Private Company Council to ensure that differences between this Proposed Framework and GAAP for private companies are minimized, and, where differences are intended, they are properly explained.

As a final comment on transparency, we understand that the Proposed Framework was developed by a task force that "consisted of professionals and staff who have an abundance of experience serving smaller- to medium-sized entities or who have worked directly for such organizations." While we do not doubt the capabilities of those who serve (or have served) on the task force, we are concerned about the lack of transparency of the process used by AICPA to make such appointments; especially given the broad intended use of this framework and the critical importance of independence in the standard-setting process. We encourage AICPA to make the background of current, and future, task force members known, provide insight into the appointment process (including determining how many years a task force member can serve and who is making the appointments), and supply information regarding the funding for such a task force related to ensuring its sufficient independence.

Subsequent Changes

We understand that the task force intends to review and propose amendments to this framework approximately every three to four years and that such amendments will be primarily based on input from stakeholders and developments in accounting and financial reporting.

We believe this timeline is arbitrary in nature. As with any high quality accounting framework, topics should be continually evaluated and amended, as needed, to ensure high quality financial reporting results. We believe the task force, or other authoritative body as ultimately deemed necessary, should meet at frequent intervals to ensure that the framework is updated and continues to produce the desired results.

Education

We believe that an important aspect to the standard-setting process is adequately educating key stakeholders. When new standards are introduced (such as the Proposed Framework), it is essential for preparers and users to understand the key differences resulting as a consequence of the application of the new standards. In the case of the Proposed Framework, AICPA is introducing a basis of accounting for use by small- and medium-sized entities that is an alternative to GAAP, potentially leading to a number of key differences from application of GAAP. Understanding the salient differences between the Proposed Framework and GAAP is quite consequential to the user community.

We have identified, for example, the following two specific provisions in the Proposed Framework that heighten our concerns regarding education due to their significant deviation from GAAP that is either currently in practice, or has previously been in practice:

1) *Subsidiaries:* The Proposed Framework defines subsidiaries as those with more than 50% ownership, but permits an option to use the equity method of accounting for subsidiaries.
2) *Income Taxes:* The Proposed Framework permits an option to use the taxes payable method of accounting for income taxes that would ignore the future tax effects of certain current transactions.

These examples are not isolated and many other areas of the Proposed Framework appear to fall short of the robust guidance that we expect will necessitate significant education and interpretation by key stakeholders upon adoption and implementation.

Another concern we have related to the education of key stakeholders surrounds subsequent changes to the Framework. Given the shortened timeframe that has been adopted for its initial issuance, we are concerned that subsequent changes to the Proposed Framework may also be adopted with limited education, awareness, and due processes.

Further, there is not an adequate understanding of the salient differences between the Proposed Framework and GAAP, and there is a fundamental lack of awareness by both financial statement preparers and users regarding the Proposed Framework. Specifically, in preparing our response to the Proposed Framework, several members of CFMA conducted informal inquiries of various key stakeholders. Not surprisingly, many were not aware of the existence of the Proposed Framework. Our results, while unfortunate, were not unexpected due to the timeframe in which the Proposed Framework has been rolled out.

Implementation Guidance

It is our understanding that, while implementation guidance is being developed to accompany the Proposed Framework, such guidance is not currently intended to be exposed for public comment. Consistent with our concerns regarding the timing and transparency of this process, we strongly encourage AICPA to expose this implementation guidance for public comment. In fact, we see the implementation guidance as an integral component to the Proposed Framework and, therefore, it must be given sufficient due process.

While we understand the entire Proposed Framework is being developed as a principles-based framework, the feedback we have received from our interaction with financial statement users in the construction industry is clear—any framework being used for financial reporting must ensure comparability within the industry from one contractor to the next. While it may not be appropriate to include significant industry-specific guidance in the Proposed Framework itself, the implementation guidance must contain sufficient guidance to ensure comparability if the Proposed Framework is to achieve acceptance in the user community. Otherwise, we believe significant risk exists for the Proposed Framework to be rejected by most users in favor of GAAP.

Finally, while we recognize a desire for simplicity and economy in the Proposed Framework, should there be insufficient guidance on relevant topical matters within the Proposed Framework, financial statement preparers and auditors will look to fill that void, with the most likely point of reference being existing GAAP. Yet, this is counter to the objective of the Proposed Framework itself. Therefore, we believe that sufficient implementation guidance, exposed to adequate due process, is required not only for acceptance in the user community, but also to ensure the ability of the Proposed Framework to stand on its own.

Definitional Considerations

AICPA has indicated there are not set criteria defining what constitutes Small- and Medium-Sized Entities (SMEs) but instead has indicated that the Proposed Framework is appropriate for all owner-managed for-profit entities whose external financial statement users have direct access to management and who are non-issuers with no intent of going public and have no requirement to report using U.S. GAAP.

Through our outreach efforts to NASBP membership and surety bond underwriters, it was clear that financial statement users had widely varying perspectives on what is meant by the term “small- and medium-sized entities”. Ninety percent of respondents indicated they did not have a clear understanding of what comprises an SME. When asked to describe how they would define an SME, responses were markedly different. Some indicated the number of employees was a defining factor—some opined employee counts of less than 200 define an SME, while others suggested less than 25 full-time employees define an SME. Additionally, many respondents suggested annual revenue should be used as a defining factor; however the amount of revenue used to define an SME varied—some indicated an SME is an entity with less than $2.5 million in annual revenues, while others suggested entities with less than $500 million in annual revenues should be considered SMEs. Several respondents also indicated the ownership must be “closely held” private entities.

With such a disparate view of the entities for which the Proposed Framework is intended, we believe it will be critical for AICPA to ensure that the financial statement preparer, user, and auditor community thoroughly understand this objective of the Proposed Framework. We believe that the Proposed Framework is intended to be appropriate for certain entities based on qualitative characteristics, principally that there is no requirement to use U.S. GAAP and that users have access to management. We recommend the name of the Proposed Framework be revised to omit the term “small- and medium-sized” as it implies quantitative measures of the size of an entity rather than appropriate qualitative characteristics. This will also require a great deal of outreach and user education to overcome a significant obstacle in gaining acceptance of financial statements prepared on a basis other than U.S. GAAP which, despite the somewhat frequent changes in its underlying accounting principles, is very familiar to preparers and users.

We also believe consistency in definitions used throughout the framework is important in achieving the objectives of the Proposed Framework. Such consistency will increase the understanding of preparers and users, and increase the efficiency in the application of the Proposed Framework upon specific sets of facts and circumstances.

One of the more significant examples we observed where such consistency could be improved is the definition of “control”; which appears to have two definitions in the Proposed Framework:

- Chapter 12 (*Subsidiaries*) and Chapter 15 (*New Basis (Push-Down) Accounting*) define control as “…ownership of more than 50 percent of the outstanding equity interests”.
- Chapter 11 *(*Business Combinations*) and Chapter 31 (*Related Party Transactions*) define control as “…the continuing power to determine its strategic operating, investing, and financing policies without the cooperation of others”.

The definition applicable to Chapters 12 and 15 is a rules-based definition that provides a bright-line evaluation of whether one entity controls another. This definition of “control” does not appear to take into account whether ownership of a majority equity interest equates to truly being able to control the investee. The definition applicable to Chapters 11 and 31 is a more principles-based definition, which would allow for such an evaluation.

Additional undefined uses of the term “control” include:

- Chapter 13 (*Consolidated Financial Statements and Noncontrolling Interests)* uses the term “control” without specific definition of the term. A reader of the Proposed

Framework might infer use of the term "control" to be aligned with the definition from Chapter 12 due to paragraphs 13.31 – .35 and the discussion of accounting for the loss of control of a consolidated subsidiary, but it is unclear.

- Chapter 14 (*Interests in Joint Ventures)* uses the term "control" in the definition of "joint control," aligning it more closely with the definition of "control" within Chapters 11 and 31.
- Chapter 19 (*Investments)* uses the term "control" in paragraph 19.04 which, as used in the context, aligns more closely with the definition of "control" within Chapters 11 and 31.

Targeted Considerations

<u>User Considerations</u>

From a construction industry standpoint, the three primary users of private company financial statements are 1) an entity's owner(s), 2) its bank, and 3) its surety bonding company. The most prevalent may be surety bonding companies as, without surety bonding credit, many construction companies cannot procure public work. Because sureties rely upon contractors' financial statements and disclosures, we conducted a poll asking sureties to determine their acceptance or resistance to a new, non-GAAP, reporting framework. Our questions were posed to members of NASBP and surety bond underwriters. 122 surety professionals across the country responded and provided incremental commentary. We believe that these responses from a key user group will be of benefit to AICPA as they continue to assess the Proposed Framework. We are happy to discuss with AICPA more specific responses and commentary upon request.

The following represents a summary of responses.

More than eighty percent of the respondents believe they have direct access to management. Approximately two-thirds are aware of the proposed new reporting framework, yet most expressed a preference for GAAP financial statements. Therefore, for the framework to become a successful alternative, significant additional outreach efforts will be needed and users will need to believe that they will still see consistent measurement of key financial statement components as compared to GAAP. Nonetheless, those contractors with larger credit lines will almost certainly continue to be required to provide GAAP financial statements.

However, many did acknowledge that there may be justifiable reasons not to prepare GAAP statements for certain entities as, for example, GAAP can be "overkill for smaller entities" thereby seeming to pave the way for a potential other comprehensive basis of accounting framework for private entities. However, most were clear that understanding the differences in financial statements and disclosures prepared under a non-GAAP standard vs. GAAP is critical.

The ED lists four attributes that should be in place for use of the Proposed Framework. Respondents had these thoughts related to each:

1) *Objectivity:* Three-fourths of the respondents did not believe management-prepared financial statements under a non-GAAP framework could be free from bias. Most stated the continued need for independent CPA involvement for annual audits or reviews (compilation information is commonly accepted on an interim (non-fiscal year-end) basis). More than two-thirds of the respondents would not accept stand-alone internally

prepared statements under a non-GAAP framework, meaning they would still require accompanying CPA attestation reports.

2) *Measurability:* Half of respondents believe management-prepared financial statements under a non-GAAP framework could permit reasonably consistent measurements. However, many also stated that much consistency would be lost between different contractors. Almost three-quarters of the respondents stated consistency and reliability under the new framework would be lost when compared to the GAAP framework.
3) *Completeness:* Half of respondents believe management-prepared financial statements under a non-GAAP framework could be sufficiently complete so that those relevant factors that would alter their conclusion about the statements are not omitted.
4) *Relevance:* Almost two-thirds of the respondents believe that management-prepared financial statements under a non-GAAP framework can be relevant for their use (subject to the above considerations).

More than eighty percent of the respondents stated that receipt of financial statements under this new framework would have a negative impact on credit capacity and/or pricing decisions. However, almost eighty percent of respondents believe that GAAP-required disclosures can be reduced and still provide relevant information to them. Almost ninety percent of respondents believe historical cost should continue to be the primary measurement basis.

Specific Accounting Considerations

This section of our response contains certain targeted considerations aimed at the PoC method and related guidance contained within the Proposed Framework.

In the U.S. for nearly thirty years, companies in our industry have been primarily following one standard when it comes to the accounting for revenue recognition: Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (now known as Accounting Standards Codification 605-35). This is a developed and time-tested standard and well understood by preparers, users, and auditors alike. It's a standard that we believe works well for the truly unique aspects of our industry. Further, while we acknowledge that upon the effective date of the Proposed Accounting Standards Update, *Revenue Recognition (Topic 605): Revenue from Contracts with Customers* aspects of existing guidance will be eliminated, we believe that, for many contracts, the accounting results will nevertheless be similar to the results provided by existing PoC guidance.

As written, we believe the Proposed Framework may be inadequate in comparison to both the existing and proposed GAAP guidance and, without substantial modification, this Proposed Framework could yield results that are incompatible with the expectations of preparers, users, and auditors. For example, as written, it is unclear whether the following subjects, among others, are effectively addressed:

- Types of contracts for which this guidance is applicable;
- Contract modifications (e.g., change orders (both approved and unpriced));
- Contract options, claims, penalties, and incentives; and
- Provisions for anticipated losses on contracts.

We encourage AICPA to consider this lack of guidance for those situations unique to long-term contract accounting and ensure that a final framework includes sufficient guidance to ensure consistency in practice.

Through our outreach efforts to NASBP and surety bond underwriters, it is clear that these financial statement users are not only interested in the continued use of PoC but, moreover, there is a clear perspective that the historical tenets established by ASC 605-35 (and as principally continued in the proposed FASB revenue standard) should be continued in this Proposed Framework. Indeed when respondents were asked whether it was preferable to continue to receive contractor financial statements prepared under the PoC method, 89% responded in the affirmative. Similarly, 89% of respondents indicated that they would still prefer receipt of those statements, even though these PoC statements would not be GAAP. Finally, 99% of respondents indicated that they would like the same historical guidance to be followed in the Proposed Framework for items such as unpriced change orders, claims, and loss jobs.

These overwhelmingly one-sided responses clearly reflect not only the interest of these users to see the continued use of PoC, whether or not under a GAAP or non-GAAP framework, but equally importantly, there must be sufficient guidance to ensure that historical safeguards and rules remain in place. This translates into an opportunity for AICPA to provide this significantly-sized industry a viable alternative framework. We encourage AICPA to carefully consider what we believe these users have clearly stated: this framework could be viable if guidance is properly augmented.

In addition to the considerations already noted, we observe the following:

<u>Paragraph 27.06</u>

There appears to be a slight departure from previously established GAAP in that the Proposed Framework could be interpreted to provide users a broader option/choice between the PoC method and the completed contract method in certain circumstances. Generally the only option for using the completed contract method is when the entity does not have the accounting records and/or the ability to estimate costs in order to calculate percentages of completion for its contracts, or the results between the two options do not materially differ. As a result, use of the completed contract method is not common. We recommend that AICPA require financial statement disclosure as to why the PoC method is not being used for reporting long-term contracts should entities reach a conclusion to use the completed contract method.

Further, the Proposed Framework states that the input to the PoC calculation is achieved based on “reasonable assurance” of measuring the “consideration that will be derived”. Consideration and related billing schedules in a long-term contract are generally based on contractually agreed upon terms, which is often independent of the true measure of progress on the contract. AICPA should therefore make it clear that revenue generally should not be recognized as billed, unless such billing pattern was commensurate with the economic progress of the contract. Further, it is unclear to us what AICPA means by the term "reasonable assurance" and that such term could be construed as a quantitative threshold. We believe AICPA should clarify that this term is intended to be qualitative in nature (e.g., verifiable historical evidence exists to support the PoC calculation and its related inputs).

<u>Paragraph 5.17</u>

This paragraph specifically refers to “progress on uncompleted contracts” being an “accounting estimate”, with subsequent paragraphs stating that estimates are “an essential part of the preparation of financial statements” (5.18) and that they may need revisions (5.19), based on “new information or more experience”. Paragraph 5.19 further states that a change in estimate is not a prior period correction of an error. Accordingly, these paragraphs appear to be on point. However, this specific point could be strengthened by adding the words “under the percentage-of-completion method” to the end of subparagraph 5.17(d).

In closing, we respect AICPA's commitment to providing high-quality, operational financial reporting standards for financial statement issuers and users related to small- and medium-sized entities. Again, we are grateful for your efforts and welcome the opportunity to meet with AICPA to further discuss the content of this comment letter.

Sincerely,

Stuart Binstock
CFMA President & CEO