AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

October 22, 2010

via email: director@fasb.org

Technical Director
Financial Accounting Standards Board
301 Merritt 7
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File Reference: No. 1820-100, Proposed Accounting Standards Update, Revenue Recognition (Topic 605), Revenue from Contracts with Customers

Dear Sir or Madam:

On behalf of the Associated General Contractors of America (AGC), I respectfully submit the following comments in response to the Exposure Draft, *Revenue from Contracts with Customers*. AGC appreciates the efforts of the Board and its staff in preparing the Exposure Draft and for the opportunity to comment on the proposed principles.

AGC is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7,500 of America's leading general contractors, and over 12,500 specialty-contracting firms. Over 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings and industrial facilities, highway and public transportation infrastructure, water and wastewater systems, flood control and navigation structures, defense installations, multi-family housing, and more.

The construction industry has played a powerful role in sustaining economic growth, in addition to producing structures that add to productivity and quality of life. Unfortunately, the construction industry has suffered as a result of the economic downturn. Whereas the construction industry provided jobs for 7.7 million workers in August 2006, there are currently 5.6 million workers in the industry (down 27 percent). The industry's unemployment rate in September 2010 was 17.2 percent, not seasonally adjusted, nearly double the all-industry rate. Nonetheless, the construction industry is a significant source of good-paying jobs, is a major customer of U.S. manufactured goods, and makes a large contribution to U.S. Gross Domestic Product (6.4 percent in 2009).

We have framed our comments along the lines:

- Overriding concerns about subjectivity and lack of comparability
- Concerns about the identification of performance obligations
- Concerns regarding variable consideration
- Concerns regarding continuous transfer
- Concerns regarding contract changes
- User concerns

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- Cost/benefit challenges to adoption of the standard

We have referred to existing standards throughout this letter using both codification and pre-codification references.

Subjectivity and Comparability

While we appreciate that the Board believes that a single revenue recognition standard will create better comparability across industries and companies within an industry, at least in the case of the construction industry, the proposed standard will introduce enormous ambiguity and uncertainty because of the standard's inherent subjectivity. This subjectivity can be broken down into two types: deliberate manipulation and unintentional confusion created by the standard's language.

1. Deliberate Manipulation. In most construction companies, there is likely only one financial officer who is the sole decider of the application of U.S. GAAP in his/her company. When that officer makes a decision as to the number of performance obligations in one of the company's contracts, that officer's decision is likely final. Thus, U.S. GAAP becomes U.S. GAAP according to the company's financial officer of any given company. There is no consistent application wording in the standard that would give direction as to how to handle any given kind of contract. This fact pattern leaves the door open for intentional, nearly undetectable, manipulation of earnings via the officer's selection of the number of performance obligations and how the contract price is to be allocated to these performance obligations. Worst of all, the officer can do this for each and every contract depending on the earnings he or she is attempting to show the company's bonding company that year.

2. Unintentional Confusion. For example, for a company with a contract for a multi-million construction project, the company could break the contract up into any number of performance obligations for each of the several separate and distinct items that form the price contract. Alternatively, the company could break the contract up into performance obligations for self-performed versus subcontracted work, or by crew. The possibilities go on and on and are unpredictable in a manner that makes sense to all readers of the proposed standard. This defines accounting chaos. Even the most honest and diligent financial officer will be put in a no-win position because he or she can and will be second guessed by the head of the company and outside CPA. The pressure on the financial officer to create earnings will be intense and this pressure will obviously lead to bad accounting.

Specific Concerns Regarding the Identification of Performance Obligations

A contractor's contractual promise to its customer is to perform construction work and/or construction management services for a project (building, road, bridge, plant) in accordance with the customer's specifications. The customer's contractual promise is to pay the contractor, generally in monthly installments as work progresses, for construction of the specified asset. Although a contractor continuously procures, performs, manages, and transfers a multitude of highly inter-related goods and services over a period of time, the contractor's single performance obligation is the timely completion of a properly constructed asset. Correspondingly, contractors should account for the continuous transfer of a project as a single performance obligation. Existing U.S. GAAP for construction-type contracts (paragraph 605-35-25-4) appropriately provides:

> *The basic presumption should be that each contract is the profit center for revenue recognition, cost accumulation, and income measurement. That presumption may be overcome only if a contract or a series of contracts meets the conditions described for combining or segmenting contracts.*

In contrast, in paragraph 22 of the Exposure Draft, an entity must identify separate performance obligations if a good or service is considered distinct. Most typical construction projects include the delivery and performance of hundreds of goods and services, or more. Through various (mostly verbal) communications, the FASB has indicated that they do not expect implementation of this change to result in numerous separate performance obligations for a single construction contract. However, considering the definition of a distinct good or service, it seems possible that many performance obligations could be identified in a single contract. While this may not be the FASB's intention, it is possible that the guidance can be interpreted in a way leading to such a result. Worse yet, such separate accounting could facilitate premature (or delayed) recognition of revenues and/or earnings (e.g., overweighting front-end standalone selling price estimates or assigning higher distinct profit margins to early activities).

Paragraph 23 of the Exposure Draft defines what is meant by a distinct promised good or service. One qualifying characteristic of distinct is whether the entity, or another entity, sells an identical or similar good or service separately. This is one of the most difficult and counterintuitive aspects of the proposed guidance. On any particular construction contract, for almost any aspect of the job, a customer could find a contractor that would perform this aspect of the work separately (i.e., you could hire an electrical contractor to hang a single light fixture). Yet, clearly, each light fixture should not represent a distinct performance obligation.

Recognizing that this criteria on its face is limited, additional guidance is provided by suggesting that distinct function and distinct profit margin can help to further delineate separate performance obligations. Yet, when looking at building project, each trade provides services that result in distinct function and each trade also has its own distinct profit margin (i.e., there is more risk, and hence profit, for a mechanical contractor than there is for a painting contractor). So, even this guidance has very real practical limitations. To compensate for these limitations, the Boards have introduced the ideas of services that are highly interrelated with inseparable risks (e.g., see paragraph BC 57). Yet, there are still very real limitations to this guidance because there are still significant and unnecessary judgments involved in making these assessments.

Now, contrast these separation criteria with the combining criteria contained in paragraph 13 of the proposed standard. One would expect that the separation criteria should be the mirror image of the combining criteria, but the way the standard is written, that is not the case. In fact, we believe that combining criteria is an excellent proxy for helping to ascertain whether or not a performance obligation is distinct and its philosophical tenets should extend into the separation criteria. Specifically, we believe that if multiple potential performance obligations are entered into at or near the same time, are negotiated as a package with a single commercial objective and are performed either concurrently or consecutively then it only makes logical sense that they should be combined and accounted for a single performance obligation. The Boards need to create an exact mirror image in the separation criteria to correspond with the guidance for the combining criteria. Otherwise, internal inconsistencies will exist within the standard.

Alternatively, we believe that the original segmentation criteria from SOP 81-1 in paragraphs 41(a) through (g) should be retained in its entirety as a suitable alternative to the above approach. Right now, the standard only seems to retain the guidance from paragraph 41(c), yet retaining this guidance alone is insufficient.

Concerns Regarding Variable Consideration

Participants in the construction industry frequently engage in contracts which provide both incentives for early completion and disincentives for late completion. Sometimes the incentives are binary (i.e., an "all or nothing" bonus arrangement if a specified target is hit). Other times, the bonus or penalty accrues at a rate that coincides with a time continuum (i.e., a fixed amount per day for each day early or each day late). Finally, contractors may share in bonus incentives for controlling project costs and/or can be penalized for the failure to do so (present in many "CM at-risk" arrangements).

We believe that the ideas contained in the guidance related to variable consideration are inappropriate in that the guidance not only permits but requires contractors to make estimates about the amount of variable consideration that they will receive. Even though the Boards have attempted to provide operational guidance as to how variable consideration should be measured in paragraphs 36-42, we believe that the guidance, particularly when taken in conjunction with further guidance in paragraphs BC81 through BC83, can and will lead to inappropriate accounting. This goes back to our concerns about the enhanced opportunity for manipulation and the potential for confusion about the intent of the standard which may create misapplication of this proposed method.

As you can appreciate, under the proposed guidance, it is almost certain that two contractors with very similar contracts (and very similar experience) will reach different judgments and will thus account for incentives differently which will result in reporting two different rates of profitability on similar contracts.

Moreover, the auditability of these assertions is extremely difficult, and can lead to substantial differences in judgment between a reporting entity and its auditors.

As others have suggested, the alternative of estimating a probability-weighted amount to be recognized seems arbitrary and the feedback we have received from financial statement users indicates significant reservations to recognizing revenue before its realization becomes at least 'reasonably assured'.

Further, there is a conformity rule under U.S. tax regulations which requires that incentive compensation be included in taxable income once the incentive compensation is recognized for book purposes. This imposes an added cost the contractor by requiring them to pay tax on variable consideration before the collection of this consideration becomes certain. The practical outcome that results from this environment is that contractors who are motivated by tax outcomes will ignore the rules contained in this guidance. The better accounting approach is to write a standard that will be respected and followed in practice by eliminating probability-weighting and instead use a high threshold for recognition, such as ‘reasonably assured’.

Concerns Regarding Continuous Transfer Concept

We generally agree with the guidance related to continuous transfer and customer acceptance as outlined in paragraphs 32 and 33, IG63 through IG73 and BC73 through BC75. However, we believe that there are key concepts from the original SOP 81-1 document which should be carried over as well. While we know that many of these concepts do not apply outside of construction-type or production-type contracts, this guidance is still essential in those contexts. Specifically, the guidance from paragraph 50 regarding uninstalled materials should not be lost under the new standard. While the Boards may believe that they have implicitly dealt with this consideration, within the context of paragraph 33(b), it seems logical the some readers could reach a conclusion that costs incurred on materials, whether installed or not, could be counted in the calculation of contract progress. We believe that the Boards should clarify their intentions regarding such costs.

Further, the guidance in the Exposure Draft contains a clear bias in favor of output measures vs. the use of input measures. While input measures are not prohibited in the guidance, they are certainly not recognized as favored status.

The overwhelming majority of contractors today utilize input measures to measure contract progress as this is the only practical expedient for determining ongoing revenue recognition.

We oppose any bias that favors output measures over input measures when, for the overwhelming majority of our constituents, input measures are the only practical way of measuring revenue.

Concerns Regarding Contract Changes

From our discussions with numerous contractors and sureties, there remains substantial confusion regarding how contract changes should be accounted for under the proposed standard. This is an area where guidance needs to be clarified.

Further, we believe that existing guidance for how contract changes should be accounted for should be retained. Generally, changes which have occurred without customer authorization as to scope result in no additional income recognition. Changes that have been approved by the customer as to scope, but not yet priced, which happens in a number of circumstances due to complexity (not the risk of non-payment, but simply a complex bureaucracy involving approval of price changes) generally permit the recognition of revenue equal to contract price and changes that are fully approved are counted in revenue once that approval occurs (assuming the work has already been performed). This guidance is incredibly logical, easy to apply, easy to audit and preferred by users of the financial statements. We believe that this guidance should be retained without modification as the preferred method of accounting for contract changes once the new revenue recognition rules are adopted.

User Concerns

We recognize that the Boards have already started hearing significant feedback from the user community of contractor financial information, most significantly being the surety industry. With many sureties also being members of AGC, we simply echo those concerns.

There is an overwhelming sense within surety community that the Boards should not attempt to fix something that isn't broken and that the way the proposed changes could be applied to the construction community would result in a significant step backwards in financial reporting. We could not agree more with these views. The tenets that exist from the original SOP 81-1 continue to meet the needs of financial statement users very well and the proposed standard must retain these key provisions as it relates to the construction industry.

In fact, the overriding concerns expressed by the sureties in their letters is that the contract is the profit center, that they bond contracts, not performance obligations, and that they want to see statements presented where percentage of completion accounting is determined at the contract level. We fully support the concerns they have expressed.

If these user concerns are ignored, the Boards risk taking something that is considered very good accounting and replacing it with bad accounting.

Practical Limitations and Cost/Benefit Challenges to Applying the Proposed Standard

Contractors will incur substantial incremental additional costs if they are required to apply this standard as it is currently written.

First, the Boards need to clearly understand that contractors manage their businesses around the contract itself. Right now, the accounting requirements under SOP 81-1 square very closely with underlying business practices. The proposed rules would significantly alter this course by substituting arbitrary performance obligations for the contract as the primary accounting profit center.

Contractors will not alter their business practices to fit U.S. GAAP accounting rules, so the clear result is that substantial additional overhead will be created in order to have information that meets the needs of the business and to provide reporting under the proposed revenue recognition rules. Such costs come with no justifiable benefit whatsoever since the industry is being asked to adopt a standard that is inferior to existing accounting guidance. On its face, the cost/benefit argument of a new standard that departs from SOP 81-1 has failed.

Disclosures

While we generally agree that it is necessary for proposed disclosure requirements to be significantly more robust than current requirements in order to ensure sufficient transparency around the increased amount of judgments and subjectivity associated with applying the new guidance, the proposed disclosure requirements, in particular the requirements related to the disaggregation of revenue, are unclear and could result in varying interpretations of the most appropriate manner in which to disaggregate revenue. For example, some companies might choose to disclose a revenue disaggregation based on geographic region, while another similar company might choose to disaggregate revenue based on performance obligations type and another perhaps by customer. The resulting variances between the types of disclosures presented by similar companies would render the financials statement less useful to the users of the financial statements, such as banks and sureties who rely heavily on comparability and benchmarking to make business decisions.

<u>Potential Issues with Taxing Authorities</u>

Contractors who undergo field audits or desk audits of long-term contracts are, under today's accounting rules, able to rely on book and financial statements to support computations of revenue for tax purposes. Under the proposed rules, the disconnect between the two methods would be so significant that it would not be practicable for a revenue agent to rely on financial statements for comparison. This potentially will open contractors to time-consuming revenue reconciliations or some other type of additional proof or documentation to substantiate tax return positions.

It would also exacerbate the current problems found in disclosures required by U.S. tax reporting related to book-tax differences. For most contractors, these disclosures are made on Form M-3. This form has a line that is specific to long-term contracts where a summary of book-tax differences must be shown. On audit or examination, contractors are, under today's accounting standards, frequently asked to prove or reconcile the book-tax difference that is shown. With the adoption of the new revenue recognition rules, a similar request would put a significant burden on contractors to provide satisfactory reconciliations.

In conclusion, AGC is committed to working with the FASB/IASB in arriving at workable solutions that result in improved financial reporting and transparency. We will continue to offer our assistance in working to improve the standard setting process initiated by this exposure draft.

Thank you for your consideration of our views.

Sincerely,

Karen B. Lapsevic
Director, Tax, Fiscal Affairs, and Infrastructure Finance