



LETTER OF COMMENT NO. 3

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To: Director - FASB

Subject: File Reference NO.1660-100

Technical Director
Financial Accounting Standards Board
401 Merritt 7, PO Box 5116, Norwalk,
Connecticut 06856-5116

File Reference no.1660-100

Discussion Paper

Preliminary Views on Revenue Recognition in Contracts with Customers

Dear Director,

Thank you for the opportunity to provide comments on this Discussion paper. I am the Executive Vice President/CFO of a 54 year old mid-size (\$30-\$35 million), privately owned Construction Company. As such, my comments to follow will primarily address revenue recognition principles for construction contractors since that is my area of expertise with over 27 years experience in the industry.

My responses to your "Request for Comments" follow.

Questions:

- (1) *Do you agree with the Board's proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? How would you address inconsistency in existing standards that arises from having different revenue recognition principles?* No. Historically, revenues are recognized when they are realized or realizable, and are earned (when goods and/or services are transferred or rendered.). Under the matching principle expenses are recognized when goods and/ or services are transferred or rendered and offset against revenues generated from those expenses. Applying the Board's proposed model would violate these principles, causing mismatching of costs vs. revenues for long-term contracts. As shown in the Board's Example 5:Construction-continuous transfer of assets (A42), the entity would show no gross margin earned during the quarter ended June 30, thereby reflecting a loss for the quarter equal to its overhead incurred, even though the contract on floor 1 was 50% complete and is projected to make a gross margin of \$50,000. This gross margin was intended to both cover overhead and provide a net profit return to the owners. Changing the example's facts a little, say that at June 30 floor 1 was only 40% complete, all other facts the same, the revenue recognized using the Board's proposed model on floor 1 would be \$240,000 with costs recognized of \$300,000, thereby showing a

\$60,000 loss for the quarter, whereas under existing GAAP (ALT B method SOP81-1) revenue would be \$320,000 (\$300,000 cost incurred + 40% x \$50,000GM), resulting in a \$20,000 gross margin for the quarter. This recognized \$20,000 gross margin would be better matched against what it was designed to provide for, i.e. cover overhead and provide a profit as the contract progresses. To me, the \$80,000 swing between existing GAAP and the Board's proposed model's example would be difficult to explain to the users of our financial statements when the management and ownership can clearly see that the contract shows that it will make a profit. The inconsistency in revenue recognition accounting standards for different industries is necessary due to the wide diversity between the industries and how they go about generating their revenues. The matching principle allows better evaluation of actual profitability and performance (shows how much was spent to earn revenue), and reduces problems caused from mismatch between when costs are incurred and when revenue is realized.

- (2) *Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information?* Yes. Long term construction contracts are examples where the board's proposal would not provide decision useful information. Recognizing revenue on a construction contract only as certain performance obligations are satisfied within that contract will create a tremendous amount of additional tracking. Construction costs on all performance obligations will be expensed as incurred with only the revenue from satisfied performance obligations within a contract recognized. This will result in costs incurred on incomplete performance obligations falling to the bottom line without corresponding revenue being recognized. The Board proposes to recognize estimated losses on "onerous" performance obligations and ignore estimated savings on other performance obligations within the same contract. Why should a company report an interim loss on a contract which when all factors are considered is estimated to result in an overall profit?
- (3) *Do you agree with the Board's definition of a contract?* No. If the "Black's law dictionary" definition is the commonly used definition within the U.S., use it to alleviate any possible confusion.
- (4) *Do you think the Board's proposed definition of a performance obligation would help entities identify consistently the deliverables in (or components of) a contract?* No. In a long-term construction contract, there are many factors which can influence not only the types of performance obligations but also the valuation of performance obligations. These include the basic contract price, change orders, claims, penalty provisions, escalation clauses, alternate adds and deducts, performance and savings incentive clauses, customer furnished materials, special warranties, etc. All of these variables make it impractical to break down the contract tracking into the separate promises to transfer assets within a contract and to assign values and costs at the performance obligation level. Most large contractors are already tracking their costs in much greater detail than at a performance obligation level and therefore would now have to aggregate costs by performance obligations, aggregate actual common costs and then allocate to each

performance obligation each reporting period, allocate the estimated future common costs to complete to the remaining performance obligations having to take into consideration when the separate performance obligations would be projected to be satisfied, compare to the allocated transaction price of each individual performance obligation, and then recognize any losses on the performance obligations being estimated as onerous, and then recognize revenues on performance obligations that have been deemed to be satisfied. This would be an arduous task on a contract by contract basis.

- (5) *Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the assets to the customer?* No. The timing of when a performance obligations asset is transferred is not certain and subject to significant change after bid time. The project could have been estimated to transfer assets at different times with some overlaps but when the start of work begins the actual transfer of assets could instead occur simultaneously or in a completely different sequence than was estimated. SOP81-1 provides guidance on segmenting a contract. This same guidance could be used to separate a contract into its performance obligations.
- (6) *Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation?* No. The satisfaction of a performance obligation is to transfer assets to a customer. A return policy negates a previously satisfied performance obligation but does not create a new obligation other than to refund consideration paid by the customer.
- (7) *Do you think that sales incentives ... give rise to performance obligations if they are provided in a contract with a customer?* No. I would think these are contingent liabilities since nothing is exchanged unless the customer creates a new contract or cashes the reward.
- (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?* Yes. Although under long-term contracts, the performance obligations are being continuously satisfied and as such would require continuous recognition.
- (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?* Yes. Cost plus fee type contracts generate revenues as costs are incurred regardless of when separate performance obligations are satisfied within the contract. Other examples are repair and restoration work, projects without adequate plans, one contractor taking over work for another contractor in mid-stream of construction, and design build projects where the scope of work is constantly changing. The contract is the profit center for contractors and their financial statement users. They want to know what profit (loss) a contract is expected to result in. Individual results on performance obligations within a contract provide no meaningful information to them. The users expect the contractor to learn from their mistakes on past projects when bidding new work. A user of the contractor's financial statements primarily focuses on the bottom line, not the top line. They view the backlog and the expected margins on that backlog in looking at projections for the entity.

Deferring revenue on ongoing work until the related performance obligation is satisfied will make these projections extremely unreliable since you would now have to project when each performance obligation within a contract would be satisfied. Due to the many variables that occur in the normal construction cycle, these types of projections would be impractical to obtain on a performance obligation by performance obligation level.

- (10) (a) *Do you agree that performance obligations should be measured initially at the transaction price?* When you view the value of each separate performance obligation as a miniature subset of the total contract amount (transaction price) and are attempting to recognize revenues by performance obligation, then some form of allocation method of the contract amount (transaction price) would be necessary. The sum of the values of all performance obligations would be equal to the contract amount at inception. (b) *Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation?* No. I would not recognize any loss on a single performance obligation if the sum of all the estimated margins within all performance obligations within that contract exceed the losses on the onerous performance obligation. Until the cost for the overall contract is estimated to exceed the overall contract amount, a loss should not be recognized on just one component of the contract. Under current GAAP, a contractor's management already has the task of explaining the reasons of their profit fluctuations on contracts to their users. It would seem rather embarrassing to cry wolf on a contract for recognizing a estimated loss on a performance obligation whereas profits on other performance obligations within the same contract could more than absorb any losses on the onerous obligations. (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 date?* Yes. Any contract which will show an overall profit should not be reflecting artificial losses to its users. There are always differences between actual and estimates. Cost fluctuations are a normal business consequence within any contract. Methods of recognizing the fluctuations are clearly spelled out in existing GAAP and the proposed model will not enhance anything more to the user. If our company makes a \$100,000 profit on a \$1,000,000 contract, does it matter to the user that the 1st floor lost \$20,000 but the other 9 floors made \$120,000? I fail to see the Board's point in this matter. What decision useful information is provided to a user of the contractor's financial statements for a contract in process and a loss has been recognized on an estimated onerous performance obligation whereby other non-onerous performance obligations will ultimately absorb that loss and show an overall gain? (d) *Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach?* Yes. Long-term contractors should continue to follow SOP81-1 guidance and not be subject to this new proposed revenue recognition model.

- (11) (a) *Do you agree that any amounts an entity charges a customer to recover costs of obtaining a contract should be included in the initial*

measurement of an entity's performance obligations? Yes. The dilemma faced with costs of obtaining contracts is that most of these costs are expended prior to becoming the successful bidder on a contract. However, in the construction industry, most of these costs have unsuccessful results since only a small percentage of bid work is awarded to the contractor. A contractor's bid margin generally includes a factor to cover not only the direct costs of obtaining that contract but also a factor to recover for unsuccessful bid costs of projects the contractor bid but was not awarded. Therefore, accounting for these costs as period costs as outlined in SOP81-1 paragraphs 70, 73-75 should be followed. (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?* Selling commissions is an example that may fit this mold. Since selling commissions will only be earned on awarded contracts, it makes sense to me to recognize a portion of the transaction price as revenue that relates to recovery of the commission when the commission is accrued.

(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?* No. The excess of the combined standalone selling prices of the separate performance obligations over the contract amount (transaction price) is attributable of the contractor's ability to achieve a combined cost savings incident to the combined performance of all the contract's obligations. These savings are enjoyed from sharing equipment and hoisting operations, common supervision and estimating services, sharing offices, shared unloading/stocking operations, engineering and design for the entire project, the contractor's overall financial strength and its ability to provide comfort to the customer that it will be able to complete the project for the amount bid. I would allocate the transaction price based on the estimated cost to complete (at inception) of the individual performance obligation to the total estimated costs to complete all performance obligations. This would provide the same percentage of bid margin to each of the performance obligations and would ignore all the different risk factors that each performance obligation contains as compared to standalone prices which would include all risk factors while ignoring the overlapping cost savings between other performance obligations.

(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?* No. For a construction contractor, almost everything included in a bid is based on an estimate. The time between bid award and actual start of construction work can range anywhere from days to years. The time element of money is included in the estimate and is generally included as wage and material escalation costs within the bid. I believe that allocation of the transaction price to separate performance obligations should be based on cost estimates within the bid for each performance obligation in proportion to the total of all cost estimates within a bid. *When, if ever, should the use of estimates be constrained?* When the information is inadequate or unavailable to be able to reasonably provide a reliable estimate, estimates should be constrained.

Thank you for allowing me to comment on the above issues.

Sincerely,

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