# The Surety & Fidelity Association of America

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#### Via U.S. Mail and Electronic Mail

Technical Director
File Resource No. 1820-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft

Proposed Accounting Standards Update Revenue from Contract with Customers

File Reference No. 1820-100

The Surety & Fidelity Association of America ("SFAA") is a trade association of approximately 450 insurance companies that are licensed to provide surety and fidelity bonds. SFAA member companies collectively provide the vast majority of performance bonds and payment bonds in the United States. We appreciate the opportunity to submit comments regarding the captioned Exposure Draft issued by the Financial Accounting Standards Board ("FASB").

A performance bond secures a contractor's obligation to perform fully the construction contract. A payment bond secures the contractor's obligation to pay its subcontractors and suppliers. In underwriting a contractor to determine whether to provide performance and payment bonds for a given project, the surety evaluates the contractor's financial strength to support the project and its entire operation. Therefore, sureties are significant users of financial statements. Our comments regarding the captioned Exposure Draft are from the perspective of a financial statement user and focus on the effect of the proposed revisions to construction accounting and the usefulness of the financial statement. Our comments reflect the principle enunciated in Statement of Financial Accounting Concepts No. 1: "Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions." CON1, para. 9. We provide some general comments and recommendations and then respond to specific questions posed in the Exposure Draft.

We understand that the intent of FASB is to move forward with a single standard that can be applied to different industries, while, at the same time, recognizing the different economic realities across industries. If implemented as currently drafted, the proposed standard could have several adverse effects from the perspective of the surety (as user of the financial statement).

First, the usefulness of the financial information is diminished. The surety is looking to the financial statement to answer the question: how did the contractor perform on this contract? Rather, by moving the focus away from the whole contract to a performance obligation, the financial statement is answering a different question: how did the contractor perform on this specific performance obligation?

Second, the reliability and credibility of the financial statement is diminished. The long held view, as contained in Subtopic 605-35, "Revenue Recognition – Construction-Type and Production-Type Contracts" ("Subtopic"), has been that the percentage completion method of accounting (recognizing revenue as costs are incurred) is the most reliable and accurate depiction of the transaction. The proposed standard could result in recognition of revenue only when the entire contract has been completed.

To address the diminished usefulness, reliability and credibility, sureties likely will require additional information to combine the multiple performance obligations into a single contract. In addition, sureties likely will require schedules regarding the billings and costs for each contract to determine the performance and profitability of each contract in its entirety. The surety may also require that contractors provide a non-GAAP financial statement reported under the principles of the Subtopic.

Because the proposed standard, as it is drafted, does not meet the surety's needs, the contractor may face additional costs: first, the additional costs required for the additional analysis and review to provide a financial statement under the new proposed standard and second, the additional costs to compile the accounting information the surety needs to view the contracts under the percentage of completion method. The adverse impact of the proposed standard likely will be felt most severely by small contractors who may not have the financial resources necessary to incur the additional costs.

Given FASB's intent to apply the standard uniquely to different industries, there appears a willingness to maintain the concepts set forth in the Subtopic and maintain the preference for the percentage of completion method for most construction contracts. We recommend that the language in the proposed standard needs to be clarified. We recommend incorporating more fully in the proposed standard the language of the Subtopic, as discussed below.

## General Comments and Recommendations

The proposed standard would supersede the Subtopic, which established the percentage-of completion method of accounting as the most appropriate method for most construction contracts. Paragraph 605-35-05-07 et seq. The Subtopic recognized the unique characteristics of and challenges involved in accounting for construction contracts. Construction accounting requires "measuring the results of relatively long-term events and allocating those results to relatively short term accounting periods." In addition, the revenue generation of a construction contract involves "considerable use of estimates in determining revenues, costs and profits." Subtopic, Paragraph 605-35-05-4. We are concerned that, as drafted, the proposed accounting

standard may change this preference for the percentage of completion method of accounting, thereby diminishing the value and usefulness of the financial statement.

Generally, sureties have found the percentage of completion method a reliable and accurate approach to accounting for construction contracts. The financial statement should depict the economic reality of the transaction. The economic reality of the construction contract includes the following characteristics:

- The construction contract is the profit center for the contractor. That is, the construction contract is the source from which revenues and profits are generated.
- As a user of financial statements, the surety is interested in how the contractor performs with respect to each contract, in its entirety. The measure of performance is the amount of profit generated by the contract and the ability of the contractor to produce the profit that was estimated at the inception of the contract.
- A project owner pays the contractor as the contractor progresses, and profits from a
  construction contract are generated by the activity of the contractor on the project. Costs
  are an objective and reliable way to account for the contractor's progress and activities.

The proposed standards seem to ignore the needs of the user and stray from the accepted and well-established approach set forth in the Subtopic. The proposed standard sets forth the steps to recognize revenue:

- Identify the contract with the customer;
- Identify the separate performance obligations in the contract;
- Determine the transaction price;
- Allocate the transaction price to the separate performance obligations; and
- Recognize revenue when the entity satisfies each performance obligation.

Our primary concerns involve the concept of a "performance obligation" and the effect of recognizing revenue when the performance obligation is satisfied.

Contract vs. Performance Obligation

Under the proposed standard, revenue is recognized when a contractor satisfies a "performance obligation." Thus, the focus is on the performance and completion of each performance obligation, rather than on the performance of the entire contract. Conceivably, a single contract could have multiple performance obligations, each with its own profit margin. Paragraph 22 of the proposed standard advises that each distinct good or service may be a separate performance obligation. Paragraph 23 describes the characteristics of a distinct good or service. A service is distinct if it has a distinct function and it has a distinct profit margin. Breaking the contract into multiple performance obligations has two adverse consequences for sureties. First, the user receives information that he or she does not want. Second, the standards for determining whether a service is distinct (distinct function and profit margin) are prone to significant judgment and subjectivity.

Based on discussions with FASB staff and excerpts of the Exposure Draft, FASB seems to suggest that identification of multiple performance obligations in a construction contract may be an exception to the rule in most cases. In Background and Conclusions (BC) 46 through 48, the Exposure Draft notes that a separate performance obligation is identified "only" if the good or service is distinct.

However, other parts of the Exposure Draft provide conflicting guidance and suggest that a construction contract is susceptible to being divided into separate performance obligations, thereby failing to provide the user what he or she wants, information concerning performance of the entire contract. For example, Implementation Guidance (IG) 43 describes a construction contract in which the contractor will perform site preparation, foundation development, structure erection, piping, wiring and site finishing. Because some of the services (foundation, erection, piping, and wiring) are highly related and integrated, they cannot be sold separately (a criterion for a distinct service). Further some services do not have a distinct profit margin because the risks of the interrelated services are not distinct (another criterion). However, the site preparation and site finishing can be broken out as separate performance obligations as a distinct service. A surety would not be interested in the contractor's performance of the site preparation separately. The performance of the site preparation could affect the contractor's performance on later phases of the project because these activities are interrelated and therefore are not truly distinct. This interrelatedness suggests that the concept of a distinct performance obligation should be defined such that if the performance of one obligation can alter or affect the performance of another obligation, the obligation is not distinct. A performance bond secures the contractor's performance of the entire contract and therefore, the surety's interest concerns the entire contract, rather than segments of the contract.

We recommend that stronger guidance be provided to address the concern that the Exposure Draft will result in dividing construction contracts into multiple performance obligations. We recommend that similar language of Paragraph 605-35-25-4 of the Subtopic, which addresses segmenting contracts, be incorporated into the proposed standard. That is, the proposed standard should state that the "basic presumption" is that a construction contract is a single performance obligation. Further the presumption "may be overcome only if" the contract meets certain criteria. Further, we suggest that the criteria track the criteria for segmenting a contract as set forth in Paragraph 605-35-25-13 of the Subtopic, including two key criteria:

- The terms and scope of the contract or project clearly call for separable phases or elements and
- The separable phases or elements of the project are bid or negotiated separately.

Incorporation of this language would utilize a well-known standard and provide objective and easily identifiable criteria for determining when to divide a contract (the explicit terms of the contract and a separate negotiation or bid).

### Satisfaction of a Performance Obligation

Under the proposed standard, revenue is recognized when a performance obligation has been satisfied. A performance obligation is satisfied when the good or service is transferred to the customer. Transfer occurs when the customer obtains control. Paragraphs 25-31. As noted in the Background and Conclusions, there is a concern that such an approach will result in construction contracts being recognized in a manner similar to the completed contract method, rather than the percentage of completion method. BC 64.

FASB staff (in discussions with SFAA) and the Exposure Draft indicate that the intent of the proposed standard is not to require the recognition of revenue only upon contract completion. BC 65. Paragraph 32 of the standard states that when the goods and services underlying a performance obligation are transferred to the customer continuously, an entity shall apply to that performance obligation a revenue recognition method that best depicts the transfer of goods and services, including the input method. Thus, a method similar to the percentage of completion method may be used in certain cases. BC 73 mentions a construction contract as an example of when goods and services are delivered continuously over time. BC 65 indicates that in some cases a method similar to percentage of completion would be acceptable.

However, despite these assurances, the guidance in the Exposure Draft, when applied to the realities of construction accounting, may not result in continued use of percentage of completion accounting. As noted above, transfer of a good or service occurs when the customer obtains control. A continuous transfer of goods and services occurs when the "customer has the ability to direct the use of, and receive the benefit from, the work in process (rather than the completed asset)." If the customer does not control the product as it is produced, revenue is recognized "only when the customer obtains control of the completed asset." IG 64 and 65. A review of a typical construction contract raises questions regarding whether the customer can direct the use of and benefit from the work in process. For example, ConsensusDocs documents are standard contract forms developed by a consortium of construction industry trade groups. Article 9.4 of the ConsensusDocs Standard Agreement and General Conditions Between Owner and Contractor states that the owner's payment of progress payments or partial occupancy does not constitute acceptance of the work. In addition, Article 9.7.1 authorizes occupancy of portions of the work only when occupancy has been permitted by the authorities. Thus, the benefit from the work in process, per the contract terms, is obtained only at certain points, raising an ambiguity whether the owner controls the work-in-process.

We recommend incorporation of language from the Subtopic, which has a more workable standard. The analysis under Paragraph 605-35-05-8 of the Subtopic focuses on whether the contractor has "agreed to sell his rights to work-in progress as the work progresses" rather than whether the owner controls the work in process. As noted above, there is ambiguity whether an owner controls the work-in-process per the terms of a construction contract. The rights and obligations of the parties are more readily ascertainable under the Subtopic's provisions. Paragraph 605-35-25-57 set forth the criteria for determining when the percentage of completion method is appropriate:

- Contract normally includes provisions that specify the enforceable rights of the parties;
- The buyer can be expected to satisfy all obligations;
- The seller can be expected to perform all obligations.

Applying the Subtopic's standard will result in the use of the percentage of completion method in most cases. As explained above, the percentage of completion method is preferred by sureties as the most effective means to reflect contractor performance.

In addition, the percentage of completion method has been established by the Internal Revenue Service as the required methodology for reporting taxes for larger contractors. Under Internal Revenue Code § 460, revenue from most long-term construction contracts must be reported on the percentage of completion basis. Short term contracts for small contractors and home construction contracts are excepted from this requirement. If the percentage of completion method is no longer the preferred method by the proposed standard, contractors would face additional burdens because they would still have to report revenue on the percentage of completion basis to comply with IRS requirements.

#### Responses to Questions

Question 2: The Boards propose that an entity should identify the performance obligations to be accounted for separately on the basis of whether the promised good or service is distinct. Paragraph 23 proposes a principle for determining when a good or service is distinct. Do you agree with that principle? If not, what principle would you specify for identifying separate performance obligations and why?

As stated in our general comments, sureties are concerned that the contract will be segmented into multiple performance obligations. This segmentation would significantly reduce the value of a financial statement under the proposed standard. Under the proposed standard, the accountant would have to review each contract and determine whether the contract involves a single or multiple performance obligations. Further, the review would involve a great deal of subjective judgment. In addition, as stated above, the surety is interested in the performance of the entire contract. In the vast majority of cases, a construction contract is a single performance obligation. One phase of work affects the performance of later phases and therefore, no services that are provided are truly "distinct." Similar to the approach taken in the Subtopic, the proposed standard must state explicitly that the presumption is that a construction contract is a single performance obligation. Further the presumption can be overcome only if it meets criteria similar to Paragraph 605-35-25-13 of the Subtopic.

**Question 3:** Do you think that the proposed guidance in paragraphs 25-31 and related implementation guidance are sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

As discussed above, when applying the concepts of "control" to construction contracts, the outcome is, at best, ambiguous, and likely could require the use of the completed contract method rather than the percentage of completion method. The terms of a typical construction contract raises questions regarding whether the project owner controls the work-in-process. There is a strong argument that the project owner does not "control" the work until it has been substantially completed. As the standard is proposed, determining when the project owner has control involves a greater degree of judgment, fact specific analysis and subjectivity. We recommend that the standard include a workable test to determine when the application of the percentage of completion is appropriate. We recommend basing the test on the criteria set forth in Paragraph 605-35-25-57 of the Subtopic.

**Question 5**: Paragraph 43 proposes that the transaction price should reflect the customer's credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

**Question 6**: Paragraph 44 and 45 propose that an entity should adjust the amount of proposed consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?

Questions 5 and 6 involve the incorporation of risk into the transaction price. The contract price of the contract should be the transaction price and the basis for how much revenue is recognized. When a contractor negotiates a contract or submits a bid, its price incorporates the contractor's assessment of the risk of the project, including the credit risk of the project owner. Thus, a risk adjustment to the transaction price would be duplicative and, very likely, speculative.

Question 13: Do you agree than an entity should apply the proposed guidance retrospectively (that is, as if the entity had always applied the proposed guidance to all contracts in existence during any reporting periods presented)? If not, why

A requirement that the application of the proposed standard be applied retrospectively will add to the burden of the reporting entity. Prior financial statements, if they are reported on the current year's financial statement will have to be restated. This will add to the cost and expense in making the transition.

We thank you for your consideration and would be happy to discuss our comments further.

Sincerely,

Lynn M. Schubert