SENSIBA SAN FILIPPO LLP

CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

October 21, 2010

Mr. Russell Golden Technical Director Financial Accounting Standards Board 401 Merrit 7 Norwalk, Connecticut 06856-5116

Dear Mr. Golden:

Sensiba San Filippo LLP is pleased to have the opportunity to respond to the FASB and IASB's Preliminary Views on *Revenue Recognition: Revenue from Contracts with Customers* issued on June 24, 2010.

We are a public accounting firm serving middle-market non-public companies in the San Francisco Bay Area, many of whom are construction companies. Our comments and concerns are prepared for the Committee's consideration as it relates to the construction industry.

We understand the need for conformity of revenue recognition across industries; however, we do not believe that the third party users of construction company financial statements will benefit in a meaningful way from the proposals in the exposure draft. Construction industry contracts are not necessarily conducive to passing ownership rights until the contract is complete and the project is accepted by the customer. Consequently, several of the requirements in the exposure draft would be difficult and tedious to apply with no added value to the readers of those financial statements.

We have responded to the exposure draft questions as follows, omitting questions we agreed with or that did not have specific relevance to the construction industry.

Question 1: Paragraphs 12–19 propose a principle (price interdependence) to help an entity determine whether to:

- (a) combine two or more contracts and account for them as a single contract;
- (b) segment a single contract and account for it as two or more contracts; and
- (c) account for a contract modification as a separate contract or as part of the original contract.

Do you agree with that principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

Response: (a) We agree that, depending on the terms and circumstances, combining contracts may better present the substance of an entire project. However, accounting principles that will require single contracts to be accounted for as multiple contracts due to the concept of performance obligations is not logical and has significant unintended consequences. See our response to question 2 for further discussion.

(b) Contract modifications (change orders) are very common in construction contracts and can vary greatly in size and circumstance. It may be difficult, and would certainly be <u>subjective</u>, for companies to determine which specific performance obligation a change order relates to. The proposed method may also require readjusting accounting for prior periods if some performance obligations had previously been completed. We recommend that a contract modification be allocated to the uncompleted performance obligation that most closely relates to the change order rather than split between multiple performance obligations, some of which may already be completed.

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?

Response: Standalone selling price for performance obligations would be highly subjective and difficult to determine in most construction contracts. General contractors, in particular, sell their expertise and management skills for an entire contract and would not normally sell different phases individually. Additionally, the bidding process for construction contracts is very complex and may not be easily separated for different performance obligations.

Contractors who engage in large projects currently recognize revenue based on estimated profit for the entire project. This allows the profit to be recognized evenly throughout the project. For the majority of construction contracts, this revenue recognition method more accurately represents the substance of a construction contract as opposed to recognizing revenue based on output milestones (form). For example, when building an office building, the profit for all of the various phases or performance obligations (such as site work, foundation, superstructure, etc.) is recognized ratably over the entire project under current revenue recognition guidance. Under the proposed standard, the margins for each phase or performance obligation would be different which does not represent the true intention of the entire contract and will distort estimated margins. This proposed method would not provide a consistent presentation to financial statement third party readers when assessing the individual contract or revenue as a whole.

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?

Response: We do not believe the proposed guidance is sufficient to determine when control of a promised good or service has been transferred to a customer under the terms of a construction contract. Performance obligations and/or change of control will be difficult to segregate in large construction contracts where transfer to the customer generally occurs at the end of the contract. This proposed guidance in its current form suggests that the completed contract method be used to recognize revenue for construction contracts unless performance obligations within the contract can be identified. We believe this would distort earnings of large contractors and would put contractors with long-term contracts at a disadvantage to those who have contracts that are shorter in duration.

Construction contracts are generally "at will" in nature and contain provisions that allow either party to discontinue the project before completion. Usually, a customer who terminates a contract is responsible to reimburse the contractor for costs incurred plus an amount for margin. When a cancellation occurs, the customer receives no real benefit since the project is not complete. As a result, construction contracts would rarely be subject to a reliable determination of separate performance obligations. This inherent customer right within the construction contract provides pervasive evidence that use of a cost to cost method would better match revenue to the service provided.

The proposed guidance suggests that revenue recognition based on "inputs" (cost to cost method) would be appropriate when there is continuous transfer of control to the customer throughout the contract; however it is unclear how continuous transfer would apply to a construction contract. On multiple occasions since the release of this exposure draft, the FASB has indicated that the intention of this proposed standard was not to eliminate the percentage of completion method of accounting and that the majority of construction contracts would still be accounted for under this method. However, we do not believe that this is clear within the proposed guidance. Clarity on the definition of continuous transfer is needed if the intent of the Committee is to maintain the cost to cost method for the majority of construction contracts. Please also see response to question 14.

Question 4: The Boards propose that if the amount of consideration is variable, an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognizing revenue when the transaction price is variable and why?

Response: We agree that an entity should recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Contingent revenue based on certain milestones being met should only be recognized those milestones are completed.

Question 7: Paragraph 50 proposes that an entity should allocate the transaction price to all separate performance obligations in a contract in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations. Do you agree? If not, when and why would that approach not be appropriate, and how should the transaction price be allocated in such cases?

Response: Identification of performance obligations and allocation of transaction price in construction contracts are much more <u>subjective</u> than revenue recognition that is based on cost (objective). This would result in significant additional audit procedures and judgment as well as additional scrutiny by financial statement users.

Question 10: The objective of the Boards' proposed disclosure requirements is to help users of financial statements understand the amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Do you think the proposed disclosure requirements will meet that objective? If not, why?

Response: Under current guidance, construction companies typically disclose the general types of contracts they enter into and the accounting policies for these contracts. We believe that this disclosure is sufficient for a reader to obtain an understanding of the business in order to understand the financial statements. For construction contractors, each contract is unique and goods and services being delivered can vary greatly. Under the proposed guidance the determination of performance obligations would be on a contract by contract basis, which would require this information to be disclosed for each contract that the Company is currently working on. This could potentially be hundreds of contracts (which would be excessive and provide little value to a reader).

We believe that current required disclosures about certain concentrations provide sufficient information to the reader to highlight any areas that may be of potential risk for the Company. The primary readers of the financials statements of contractors are management, lenders, and sureties. Should any of these groups desire the type of information in paragraph 74, they could request that a separate schedule be provided.

Question 11: The Boards propose that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year. Do you agree with that proposed disclosure requirement? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

Response: Although contractors generally have a good idea of how much time a contract will take, they are often held up by various things that are out of their control. Examples of this are customer demands or preferences and delays in getting required permits and/or financing. Weather can also significantly influence the completion of a construction contract. Because these external factors often dictate the timing of a contractor's work, it is nearly impossible to project when each performance obligation will be completed. We do not believe this additional disclosure would be beneficial or meaningful to the reader of the financial statements

Question 12: Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing, and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

Response: Disaggregation of revenue and cash flows in this detail will overcomplicate the usefulness of the financial statements to the current readers of construction contractors financial statements. The current literature already requires concentration disclosure which we believe to be adequate disclosure for this information.

Question 13: Do you agree that 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? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost? If so, please explain the alternative and why you think it is better.

Response: In order to apply the proposed guidance retrospectively, construction companies who issue comparative statements would have to go back to all contracts previously closed within the last two years and determine how revenue would have been recognized under the new guidance. They would have to break each contract into separate performance obligations and recognize revenue accordingly. This would be a great burden to both contractors and auditors. It is likely that private companies will issue single year financial statements; however, recalculation for the prior year will still be necessary to ensure the proper opening balance for retained earnings. Should this exposure draft become effective in its current form, we recommend that the FASB consider requiring that this guidance be applied only to contracts entered into after a certain date.

Question 14: The proposed implementation guidance is intended to assist an entity in applying the principles in the proposed guidance. Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Response: Following the release of the proposed exposure draft, we have noted that the FASB has provided the example below regarding contracts with customers and how revenue would be recognized under existing and proposed standards. We believe that this example is more representative of how revenue for construction contracts should be recognized, however the example is not consistent with our interpretation of the proposed exposure draft. We recommend that the following example be included in the exposure draft in order to clarify proposed accounting for construction contracts:

Example 1

A company enters into two contracts with separate customers to build an asset:

- Contract A the customer specifies the asset by choosing from a range of standardized options. A partial payment is due upfront with the remaining payment due upon physical delivery of the completed asset (when legal title is transferred).
- Contract B the customer specifies major structural elements of the asset and is obliged to make progress payments throughout the contract. Physical possession and legal title are transferred at the end of the contract.

Current Practice

• Could result in the same pattern of revenue and profit margin for both contracts

Proposed Model

- Contract A: revenue recognized at end of the contract (inventory would be recognized previously)
- Contract B: revenue is recognized continuously throughout the contract

Question 18: Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?

Response: Percentage of completion accounting (consistent with ASC 605-35, formerly SOP 81-1) should be allowed for non-public construction contractors given the level of sophistication of the readers of the financial statements and their familiarity with the existing revenue recognition guidance.

Additional considerations:

Although not specifically addressed in the questions above, we believe that the FASB and the IASB should also consider the following factors in regard to new revenue recognition guidance as it applies to construction contractors:

- The vast majority of construction companies (over 95%) are privately held. Therefore the need to conform to accounting standards that require revenue recognition to be uniform across all industries is less compelling than in public companies because the primary readers of the financial statements (management, bankers, and sureties) are thoroughly familiar with how construction contractors recognize revenue.
- Lenders and sureties may not accept this new revenue recognition method which could lead to an increased number of GAAP departures or requirements to provide supplemental schedules under the percentage of completion method (consistent with ASC 605-35). Supplemental schedule requirements would force contractors to track jobs under multiple accounting methods.
- The IRS could continue to require percentage of completion or completed contract method reporting, which would require contractors to track jobs under multiple accounting methods.
- Administrative costs would increase due to the fact that employees would have to learn the new method and the new method would likely require more time to track. This could be extremely detrimental to an industry that has already experienced significant declines in recent years.
- Generally small contractors are closely-held business, with minimal administrative staff, making it difficult for the staff to absorb these additional tasks.
- Current software platforms are based on existing accounting methods. Updates will likely require significant time, expense and training.
- We have reviewed several responses to this exposure draft and noted that multiple construction
 companies have replied with letters that do not address the specific questions that were offered.
 While this type of response may not be helpful to the committee in their efforts to craft and/or
 modify the proposed standard, we encourage the FASB and the IASB to consider that the
 volume of responses indicates an overwhelming concern from the construction industry
 regarding the proposed standard.

Thank you for your consideration of our comments. You may contact Steve San Filippo by phone (650.293.4001) or via e-mail (<u>ssanfilippo@ssfllp.com</u>) for any clarification or questions you may have regarding the above comments.

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