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19 June 2009

Henry Rees
Project Director
International Accounting Standards Board
First Floor
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Dear Henry

I attach the response of a number of leading construction and support services companies to the IASB/FASB Discussion Paper on Preliminary Views on Revenue Recognition in Contracts With Customers.

My fellow signatories and I found our meeting on 12 June 2009 very helpful in understanding the boards' viewpoint and enabling us to sharing our concerns with you and we would welcome the opportunity to continue the dialogue during the development of the standard.

Yours sincerely



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19 June 2009

Dear Sirs

Response to IASB/FASB Discussion Paper “Preliminary Views on Revenue Recognition in Contracts With Customers”

This response is given by a number of leading construction and support services companies who operate in the UK and internationally and have combined revenues of £29Bn and employ over 200,000 people.

We set out in Appendix 1 our detailed response to the questions raised in your Discussion Paper.

We support the initiative to develop a coherent revenue recognition standard to codify and replace the existing general guidance in IAS 18 and the industry specific guidance in various other standards, IAS 11 in the case of construction contracts.

However, we are very concerned by the implications of the Discussion Paper for accounting in the construction sector, where the effect of the proposals as currently drafted would be to defer recognition of revenue on many construction contracts until the client takes physical possession of the works, normally when construction is complete. This is a fundamental issue for the construction industry and other industries and adoption of the principles of the Discussion Paper will, in our view, de-value the use of financial statements to potential investors and other users of the accounts due to:

1. Information on current trading being delayed and therefore information will not be sufficiently timely or relevant for users of the accounts.
2. For investors and other users of the accounts a key metric relating to quality of earnings is the conversion of operating profit into operating cash. If the proposals were adopted this metric would not be meaningful.
3. Deferring revenue until construction is complete will cause significant ‘grossing up’ of the balance sheet, which may give investors, lenders and other users of financial statements a misleading picture of working capital employed in a business.
4. Introduction of significant volatility into the income statement that does not reflect the underlying economic activity will lead to loss of comparability between the financial statements of construction contractors for two reasons. Firstly, because of the distorting effect of the timing of completion of significant contracts. Secondly, because the legal provisions governing when work done on the client’s land becomes the property of the owner will differ between legal jurisdictions.

5. It is inconceivable that construction contractors will adopt the proposals in their own internal reporting systems, which will continue to recognise revenue and profit in line with the stage of completion of projects as this is much more decision-useful for management purposes. There will therefore be a divergence between internal and external reporting, in a reversal of the trend seen in IFRS 8 Operating Segments. Furthermore, to explain the apparent volatility in operating results to shareholders, analysts and other users of the financial statements construction contractors in their external reporting will inevitably supplement their IFRS accounting under the Discussion Paper proposals with non-IFRS information based on the internal management reporting on the more decision-useful stage of completion basis.
6. In addition, consideration needs to be given to how tax authorities would react to the proposed standard and how they would tax construction contracts. It is likely that in many tax jurisdictions deferring revenue and therefore profit will not be acceptable to the tax authorities as a basis for taxation.
7. Issues 5 and 6 above will give rise to significant additional costs for maintaining, reconciling and presenting the additional management and taxation information.

There are a number of areas that arise out of contracts for unique tailor made assets that the Discussion Paper does not address and where it would be helpful if the eventual standard gave guidance, in particular:

1. The level of granularity to be considered in construction contracts in assessing obligations and hence revenue;
2. Variations to the original contract specification and terms, which are normally explicitly contemplated in construction contracts and can modify the original contract terms considerably; and
3. Pain/gain arrangements where the contractor and client share the risks and benefits of changes in underlying contract costs.

Another area where the Discussion Paper is silent is the pattern of profit as opposed to revenue recognition. We have assumed that the proposals envisage that profit will not be recognised in the absence of revenue, unless a contract is onerous and a loss is recognised before the contract is complete. Clarification of this point in the eventual standard would be welcome.

As stated initially, we support the aim of developing one revenue recognition standard that can be applied to all industries. However we believe construction contracts are contracts for services from which the client obtains benefit as construction progresses and the contractor should recognise revenue as the services are performed. We do not agree with the boards' view that this typically occurs "...when the customer takes physical possession of the good" or that "...an entity satisfies a performance obligation when the customer has the promised asset and the entity no longer has it". We believe in assessing the passing of control, the boards should consider the balance of range of indicators, including but not limited to:

1. Whether construction is undertaken to the customer's specification;
2. Whether the customer can order changes to the specification during construction;
3. Whether the customer can take over the construction works;
4. Whether the customer obtains the rights to the construction works if the contract is frustrated.
5. Whether payment is governed by an external certification process.

We believe there are other service industries that will have the same issue.

We hope the boards will give serious consideration to modifying their preliminary views to address this and our other points and to give guidance on some of the unique aspects of construction contracts before developing a draft standard.

We would welcome the opportunity to meet with you while the Exposure Draft is being developed to discuss our concerns.

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Appendix 1

Revenue Recognition Discussion Paper Responses to the Specific Questions Raised in the Discussion Paper

Chapter 2: Revenue recognition based on changes in assets and liabilities

Question 1

Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

We agree with this approach. For consistency and certainty it is preferable to have one overall recognition principle rather than two or more with the potential for transactions to fall under more than one, or none, of the principles.

However we believe it will be possible within this unified framework to provide that in a contract for services, such as a construction contract, an entity's contract liability reduces as the services are rendered over the contract period. See question 8 for more details.

Question 2

Are there any types of contracts for which the boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?

We do not believe the proposals in the Discussion Paper as it stands would provide decision-useful information for long term construction contracts as they would impair comparability and relevance of reporting. These issues are outlined further in the covering letter and this appendix.

Question 3

Do you agree with the boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

We agree with the definition that "a contract is an agreement between two or more parties that creates enforceable obligations."

Chapter 3: Revenue recognition based on changes in assets and liabilities

Question 4

Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

The Discussion Paper defines an entity's performance obligation as a promise in a contract with a customer to transfer an asset (such as a good or a service) to that customer. The promise can be explicit or implicit but must create an enforceable obligation.

In principle, we agree with the notion of identifying and separating performance obligations within a contract with a customer.

However, we do not consider it appropriate to blur the distinction between goods and services. A service is not an asset in any meaningful sense and the distinction between the two is important in construction contracts, where services are rendered continually to create an asset that is completed only at the conclusion of the contract. We believe the definition should say "...to transfer goods or services to that customer". As stated previously, we believe construction contracts are contracts for services from which the client obtains benefit as construction progresses.

Furthermore, we consider that further guidance is required to clarify the level of granularity contemplated by the boards when identifying and accounting for performance obligations.

In our view, as the discussion paper currently stands and absent any further guidance, there is a significant risk that performance obligations could be inconsistently identified and/or artificially engineered within a construction contract to achieve a desired revenue profile, which will reduce the comparability and decision usefulness of financial statements. We also consider that a strict interpretation of the definition in identifying performance obligations to a high level of detail could result in a cost to preparers of financial statements that will far exceed the benefit of any additional information gained.

An example of where the definition could result in an inconsistent application (i.e. where a literal interpretation of a performance obligation is taken to its extreme) would be where one entity identifies the installation of an individual light bulb in a contract to build a warehouse as a single performance obligation as compared to another entity that interprets the performance obligation to be the delivery of a service to construct the building.

Another example of where the proposed definition could result in an inconsistent application is a long-term contract for a construction project. Typically long-term construction contracts are complex and do not specify individual components required to achieve contract milestones. Two different contractors who both treat the contract as a service to provide the building (or fit-out) services could identify performance obligations quite differently from one another and, as the service represents a continuous transfer to the customer, recognise varying levels of revenue. That is, two contractors could have different revenue recognition profiles for economically identical contracts.

As stated, we support the segmentation of performance obligations where doing so would result in more decision useful information. Where a component of a contract has been independently priced and the intention (and expectation of both parties) is to deliver that component separately but for commercial or other reasons it has been included within the terms of a larger contract (such as where a construction contract has a separate, post-build maintenance service period), we support reporting of that performance obligation's revenue and gross margin separately. However, where performance obligations in a contract are valued at prices consistent with an existing contract and where that contract had been tendered with an overall contract margin in mind, we do not consider it appropriate or beneficial to segment that contract into multiple components and report individual gross margins. For example, in our view, a contract to provide building services for a warehouse should be accounted for as one performance obligation with a gross margin recognised as the service is delivered. While various performance obligations can be identified, these would be typically priced as part of the overall contract. Segregating components and margin, such as the build of the roof or the installation of lighting, while possible, would not reflect the substance of the contract and would tend to reduce the decision usefulness of financial statements. The customer and the contractor both view the substantive performance obligation as being the delivery of a construction service for a *completed* warehouse at an overall contract margin – not the delivery of individual sub-components with different margins each negotiated within the contract. The service is the build of a single warehouse and should be reflected as such in the financial statements.

Our concern is that without clear guidance, the Discussion Paper could result in a requirement to identify and report margins for performance obligations that are derived from stand-alone selling prices which are not capable of being replicated outside of a specific contract and which do not reflect the overall substance of the contract.

While we do not believe it to be the Board's intent for the recognition of revenue in long-term contracts to change dramatically, without further guidance, particularly in respect of more complex and multi-period examples, our view is that the goal of improved consistency will not have been achieved.

Question 5

Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

As a consequence to our response to question 4 we consider an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised goods or renders the promised services to the customer.

This is on the basis that we believe construction contracts are contracts for services from which the client obtains benefit as construction progresses. Therefore revenue is recognised as the client receives benefit over the course of the contract. We believe that revenue recognition on transfer of assets for long term construction contracts would impair comparability, relevance and timeliness of reporting. These issues are outlined further in the covering letter and this appendix.

Question 6

Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

We recognise that for some industries it may be the practice for significant quantities of goods to be returned and hence refunds could be a performance obligation. However for the construction industry this is rarely relevant.

For clarification we do not think that in a construction contract work done under warranty or defects liability provisions is a separate performance obligation. The ability to return goods under construction contracts is limited and we believe any rectification works are a cost and not a revenue item.

Question 7

Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

Yes, we do believe they give rise to performance obligations and should give rise to revenue, as opposed to being regarded as a cost of obtaining the primary contract.

Chapter 4: Satisfaction of performance obligations

Question 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? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

In principle, we agree that a performance obligation is satisfied when an asset is transferred to a customer. We also agree that this transfer typically occurs when the customer controls the good or has received the service, however, we do not agree with the boards' view that this typically occurs "...when the customer takes *physical possession* of the good" or that "...an entity satisfies a performance obligation when the customer has the promised asset and the entity *no longer has it*."

Notwithstanding our view that long-term construction contracts are an agreement for the provision of construction services from which a customer obtains a continuous transfer of economic benefit, the Discussion Paper's view of what constitutes the passing of control appears to follow a legal form over economic substance approach, which is in our view too simplistic and not appropriate for the recognition of revenue in long-term contracts. This strict view would result in a movement towards a "completed contract" method of revenue recognition and not provide decision-useful information on the value (or entitlement to future economic benefits) generated by an entity throughout the life of its contract.

We are concerned by the assumption that physical possession is equivalent to control and that the asset has transferred when one party no longer has it. That is, if the entity does not have control then the customer must. Physical possession alone is not necessarily indicative of control and would contradict how customers typically recognise an asset under construction on their own balance sheets.

For example, in long-term construction contracts, although the contractor may be in “physical possession” of a construction site, there are a significant number of factors that would indicate that the contractor does not retain control of an asset. These factors may include but are not limited to:

- Construction is normally undertaken to the customer’s specification. The contractor does not undertake the construction and then look for a buyer;
- An inability to modify the specifications of the contract without express prior consent of the customer (i.e. substitution of materials, changes to the design or other modifications);
- The customer can order changes to the specification during construction.
- An inability of the contractor to transfer, resell, pledge as collateral or otherwise promise the construction asset to any third party;
- The inclusion of contract clauses which enable the customer to order the contractor off the site / cancel the contract subject to the payment of damages (which we note the Discussion Paper identifies as being a circumstance where continuous revenue recognition could occur for the construction of a good);
- That the customer has rights to materials, a legal and economic benefit, that attach to the client’s land as the contract progresses;
- A client may retake partial possession of a site even when a contract is not completed;
- The customer obtains the rights to the works if the contract is frustrated for any reason;
- That the customer makes progress payments on certification of value by an independent external surveyor *rather than* a single payment at the conclusion of the contract (as would occur in the retail industry) and typically once certified, the customer has an unconditional obligation to make payment; and
- A contractor has no legal rights in the land on which it is providing a construction service.

These factors highlight that control is not a straight-forward concept and can only be assessed on consideration of all the relevant facts and circumstances.

Similar to our response to question 4, while we acknowledge that the proposal has been published for discussion only at this stage, we strongly believe that the boards need to provide greater clarity as to how the proposed definition of control will be applied in practice and suggest that the boards should consider providing some implementation guidance which offers a range of indicators that can be used to assess the passing of control rather than looking for a single test for revenue recognition.

Question 9

The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

In principle it will provide decision-useful information though for construction contracts it will not if the performance obligation is only deemed to be satisfied upon completion of construction.

Chapter 5: Measurement of performance obligations

Question 10

In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

(a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

We agree in principle, for simplicity, but also because in most cases the transaction price and the exit price will be similar, particularly in industries such as the construction industry where clients frequently select contractors by competitive tender.

We note that the boards are yet to form a view in respect of variations and it is a topic for further discussion. This aspect is of considerable importance to the construction industry and we would welcome the opportunity to comment on draft proposals ahead of the issue of an Exposure Draft.

In the construction of unique complex tailor made works such variations are normally explicitly contemplated in the construction contract and they can modify the original contract terms considerably. Variations should be treated as a modification to the original contract, rather than a separate new activity. In practice the pricing of many variations will not reflect a separate standalone price but will depend on the extent to which the variation works can benefit from utilising the contractor's pre-existing site infrastructure and management. The prices of the original works and variations will therefore be interdependent.

The Discussion Paper also does not cater for pain/gain arrangements, where the contractor and client share the risks and benefits of changes in underlying contract costs.

(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? Why or why not?

Yes, again for simplicity.

(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 statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

We believe the proposed measurement approach of using the original transaction price, if it took into account variations and pain/gain arrangements, would provide decision-useful information for performance obligations in our industry.

(d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

We do not think any other measurement approach is relevant to our industry, so long as provision is made for variations and pain/gain contracts.

General questions

Question 11

The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (eg selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

(a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

Yes, because in practice it will be impracticable to distinguish these costs from more general selling costs and overheads.

(b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

We believe it would provide decision-useful information for most categories of contract origination costs, for instance sales commission, but not in respect of costs incurred prior to contract signature when it is virtually certain that the contract will be signed and where these costs are for goods or services that will be incorporated in the eventual contract works, for instance design costs. Such costs would not currently be expensed under IAS 11 S21 or in UK local GAAP under UITF 34.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

In principle, yes, though in practice an entity may not have stand-alone prices for some of the individual element of goods or services and so there may be a significant element of estimation. As noted in our response to question 4, guidance to clarify the level of granularity would be helpful.

The integrated nature of construction work means that it is not decision-useful or cost effective to consider obligations below the level of the overall contract for many construction contracts, in which many overlapping activities combine to produce the finished building or structure. Even taking a high level perspective, it may seem in a design and build contract that the design element and the physical works are separate performance obligations for which there are stand-alone selling prices. However in practice the two activities will proceed in parallel rather than sequentially, with the design continually developing in response to conditions encountered on site, relative progress on the various individual packages and client variations.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Where it is relevant to allocate the transaction price, we believe estimates should be used if the entity does not sell the good or service separately. The use of estimates in accounting is well established, for instance the use of future forecast cashflows, which are inherently uncertain, in areas such as impairment testing. While estimates are inevitably subjective this does not preclude them from providing reliable information if careful consideration is given to the assumptions on which they are based.

Discussion Paper Appendix C Gross versus Net Presentation of Rights and Obligations

The Discussion Paper does not request comments on the topics for future discussion but we would comment that we would prefer that the rights and obligations in the contract were presented net in the statement of financial position, as they effectively are under present practice.

Having large offsetting assets and liabilities at the inception of the contract will not assist the decision-usefulness of the financial statements.