

From: Greer, Michael [mailto:mgreer@pnat.com]
Sent: Monday, September 13, 2010 10:13 AM
To: Kenneth Bement; Robert Herz; Tom Linsmeier; Leslie Seidman; Marc Siegel; Larry Smith
Cc: Schubert, Lynn; Duke, Rob
Subject: Proposed revenue recognition changes

Re: Proposed changes to Revenue Recognition standards

Gentlemen:

Penn National Insurance Company is a provider of Surety bonds for the construction industry. Surety bonds are needed by Construction and other companies in order to bid on and perform work for various Governmental agencies.

The Surety Bonds that we provide are a form of credit. Accordingly, we are a significant user of CPA financial statements. In line with the rest of the construction industry, we require that all financial statements we receive be prepared on the Percentage of Completion basis of accounting.

We require this method of accounting because it is the best method to accurately capture the progress and profitability of construction projects.

We have reviewed your draft proposal on the changes to Revenue recognition and are firmly opposed to the changes that are being proposed. Our opposition is based on the following:

1. The new methods proposed create too much subjectivity and will lead to uncertainty for the surety companies. Specifically, the proposed revenue methods open the possibility that two different CPA's could come to two or three different conclusions about what has been transferred to the owner. There are thousands of construction firms that we look at each year. If we as surety are uncertain about the value of either the profitability or the balance sheet of a contractor, our tendency is to lower the amount of surety credit that we will offer to an account. Carrying this domino effect through results in the contractor not being allowed to do as much work which leads to them having lower revenues, they don't need as much labor; they don't buy as much materials and so on. Construction represents a significant portion of the overall economy of the United States; Surety companies are responsible for guaranteeing the completion of a significant percentage of the commercial construction work that is performed. In order to provide the maximum amount of surety credit possible, we must know with certainty the financial condition of our clients. As it stands we do not have this concern with the Percentage of completion method of accounting. Cost to Cost is exactly that, there is no room for subjectivity about whether an item is a cost component.
2. Besides creating uncertainty, the proposed new method of revenue recognition will create the possibility of having multiple parts of a contract separated out on the financial statement. When we receive work in progress schedules, we analyze each job from start to finish in order to track how the overall job performed. Since our Obligation is the completion of the entire contract, this how we want to be able to view the progress of the job. Whether they make 10% profit on the site portion of the work versus 12% on the steel portion does not matter to us as a Surety. Moreover, how much credit we provide to our accounts is a direct result of what their cost to complete backlog is relative to the line of credit that we provide. If it becomes too hard for us to track what the correct Cost to Complete backlog is, the contractor will be penalized with a lower amount of bonds approved.

If instead of one project to analyze, we now have three or five parts of the job, this creates unnecessary additional expense for us and the contractor. Additionally, if we started receiving multiple profit reports for the same job, this would make our analysis very difficult and could easily lead to faulty analysis. Moreover, no surety has the technical systems capable of combining multiple components under one job number.

3. The new methods do not give the user anything more valuable than currently exists with Percentage of Completion Accounting. The Surety Company and the Bank would not derive any additional value from the changes that are being proposed so without added value all that is created is confusion and extra costs.

4. The new methods of revenue recognition would create unneeded additional expense for the construction firms. The proposed revenue recognition methods would require significantly more of the CPA's time which would result in higher costs to the contractor.

5. Small and emerging contractors would be most hurt by the new method. The new methods would require new accounting software to be developed and purchased by the contractors. Smaller contractors are already struggling with the costs of accounting; this would be an unnecessary burden on them.

6. In our opinion, the new methods proposed are so unworkable, that it would be our company's position that we would not accept a financial statement on this new method. So in order to obtain surety credit a contractor would have to have the CPA still provide us with a Percent complete basis statement, which may or may not be in accordance with GAAP under the new methods. The contractor's Bank would more than likely require a GAAP basis statement. So in effect, the contractor will now have to pay for two sets of financial statements rather than one.

I understand that the goal of this effort was to create one unified method of accounting across various industries and countries. While that might be helpful to some industries, I suggest that a better alternative is that each Industry has a unified method of accounting. There needs to be recognition that there are major differences from one industry to the next. It does not make sense for every industry to have to be the same.

Most importantly however needs to be the recognition that the purpose of financial statements is to provide the users of the statements with information on which they can make decisions. If knowledge is lost just for the sake of having one set of rules, that would be a mistake and no one would be better off.

I am not sure what groups would benefit from the changes that are being proposed, however I can attest to the fact that the Surety Industry would not benefit from these proposed changes, in fact our ability to make credit decisions would be impaired. As a result, we would not be able maximize our and our contractor's earning potential if these changes are enacted.

I strongly urge you to exempt the construction industry from your proposal. Percentage of Completion accounting is working very well for the Construction and Surety Industry.

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