



Leighton Holdings Limited
ABN 57 004 482 982
472 Pacific Highway
St Leonards NSW 2065, Australia
PO Box 1002
Crows Nest NSW 1585, Australia
www.leighton.com.au
T (02) 9925 6666
F (02) 9925 6005

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The Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Via email: commentletters@iasb.org

Dear Chairman

Exposure Draft: Revenue from Contracts with Customers

Leighton Holdings Limited is the parent company of Australia's largest project development and contracting group. With around 45,000 employees, the Group's operations are spread all around the Asia-Pacific region on projects in Australia, New Zealand, Hong Kong, Indonesia, Malaysia, Singapore, the Philippines, Thailand, Vietnam, China, Mongolia, Laos, Cambodia, Taiwan, Sri Lanka, Macau, India, United Arab Emirates, Qatar and Brunei. Leighton Holdings Limited is listed on the Australian Stock Exchange and has its head office in Sydney.

We appreciate the opportunity to respond to the IASB's request for comments on the Exposure Draft: *Revenue from Contracts with Customers* ("ED"). Our focus on the ED is from the point of view of long term construction contracts and a general overview on the potential impacts the proposal could have on the construction industry is provided at Appendix 1. Our response to the specific IASB questions is provided at Appendix 2. In summary, as previously outlined in our reply to the Discussion Paper, we believe that construction is a service and that the unique nature of construction justifies specific guidance in relation to identification of performance obligations.

Leighton Holdings would welcome the opportunity to be involved in the further development of this standard and is more than willing to provide further submissions and/or presentations as required.

Please do not hesitate to contact me if you require any further information on our submission or would like to discuss any matter in relation to revenue recognition.

Yours faithfully
LEIGHTON HOLDINGS LIMITED

A handwritten signature in blue ink, appearing to read "Carlos Mendes".

CARLOS MENDES
Group Financial Controller
Direct line +612 9925 6030 Direct fax +612 9925 6952 Mobile +61 412 586 030
Email carlos.mendes@leighton.com.au



Overview of the Revenue Recognition Exposure Draft - Long Term Construction Contracts

1. Background

Long term construction contracts are unique and merit specific guidance in the new revenue recognition model. We believe any proposed standard would be enhanced by specifically addressing issues particular to construction.

2. Nature of construction contracts

Construction contracts are different in nature to other commercial agreements and require specific accounting guidance. Characteristics of construction contracts include:

- Long term – cover several reporting periods;
- Unique – no two construction contracts are the same;
- Specified by the client – the major structural elements of the design both before and during construction are specified by the client (this contrasts to the “manufacture of goods to a customer’s specifications”);
- Variable – contracts are written to accommodate changes in scope, time and in transaction price;
- Service – a construction service is being provided as all activities are done on behalf of the client; and
- Delivery – the customer receives the right to the work in progress during construction and is unable to return to the contractor the works in progress (for example, a partially completed road).

The IASB has also acknowledged the unique nature of construction contracts as demonstrated by the current specific accounting standard IAS 11 and the Basis for Conclusions of the ED indicates percentage of completion accounting is not inconsistent with the new revenue recognition principles BC33(d). However, as currently drafted we perceive some risk in the interpretation of the ED that could result in identification of numerous performance obligations in a construction contract that would act to prevent percentage of completion accounting. It is our view that the ED should recognise the unique bundle of services provided as part of construction contract to help avoid any such interpretation.

3. Construction as a bundle of services

The construction industry is a service industry with construction activity driven by the customer. Construction activity is only undertaken when agreed to by the customer, as opposed to creation of inventory.

As a result, we believe that a clear definition of construction as a bundle of services in the proposed revenue recognition model would:

- Ensure the model reflects the nature of construction activity where the customer specifies the main elements of structural design.

- Allow the continuation of existing percentage of completion accounting for construction contracts avoiding the potential economic and financial impacts of a model where revenue would be recognised over numerous performance obligations or only at the end of a construction contract.
- Avoid some of the practical difficulties and associated costs of implementing the proposals (discussed further below).

4. Potential impacts if construction is not defined as a bundle of services

Not defining construction contracts as a bundle of services, carries the risk of misinterpretation and resulting in numerous performance obligations in a contract which would change revenue recognition in a construction contract. This would significantly impact the construction industry.

4.1 Transfer of control

The question as to when control of the asset has transferred to the customer under a construction contract is still not clear under the ED due to the focus on completed goods and delivered services as opposed to continuous transfer of control and resulting work in progress.

4.2 Potential impacts of unnecessary identification of performance obligations

An interpretation of the ED which identifies numerous performance obligations within the one construction contract would have the following potential impacts:

- A need to hire and train staff to identify separate performance obligations and allocate stand-alone transaction prices in large and complex construction contracts.
- A need to develop new systems to record and track the satisfaction of separate performance obligations for financial reporting purposes that will overlay existing systems that need to remain focussed on measuring cost for monitoring management performance and remuneration.
- A major disconnect between financial and management reporting with substantial time and resources being used in reconciliation.
- A significant increase in additional reporting outside the primary financial statements to ensure users understand underlying performance.
- Significant tax accounting consequences of changes in accounting income compared to tax income paid on a progressive earnings basis.
- All additional costs would be passed on to customers.

Response to specific questions in the Revenue Recognition Exposure Draft

Question 1 (c)

To account for a contract modification as a separate contract or as part of the original contract?

Contract modifications should be accounted as part of the original contract.

All construction contracts include mechanisms to address changes in scope or circumstances, called “variations” or “claims” (see IAS11 13 and 14) due to the unique nature of the activities undertaken.

Under the ED it would appear that all contract modifications in the construction industry in the form of variations and claims would have prices that are inter-dependent with those in the original contract when the indicators in ED 13 are considered:

- a) Contracts are entered into at or near the same time – as variations are entered under a mechanism in the original contract they would necessarily be entered at the same time.
- b) The contracts are negotiated as a package with a single commercial objective – as with (a) above the original contract is negotiated with potential need for variations considered.
- c) The contracts are performed either concurrently or consecutively – variations necessarily would almost always be performed at the same time as the original contract or as an extension of the original contract.

Further we believe the additional indicator we suggest above in relation to “overall profit margin” would also be met by variations as they variations included as part of the overall profit on construction contracts.

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?

Yes, however we have concerns as to what level the ED would require the separate identification of performance obligations in respect of long term construction contracts.

Paragraph 22 states:

“If an entity promises to transfer more than one good or service, the entity shall account for each promised good or service as a separate performance obligation only if it is distinct. If a good or service is not distinct, an entity shall combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in the contract as a single performance obligation. ”

Paragraph 22 acknowledges that a bundle of goods or services can be distinct.

The concept that a bundle of goods or services can be distinct and the transfer of a bundle of services could result in one performance obligation is important for the construction industry being able to apply percentage of completion accounting under the ED.

Construction contracts involve the provision of a number of services, or a bundle of services, within the one contract. Due to the unique nature of construction contracts the bundle of services will be distinct from contract to contract.

However, paragraph 22 also states that accounting should be made for each good or service that is distinct before combining the goods and services as a bundle.

For example, a contractor could be appointed to construct a mixed use development comprising a separate hotel, office block and retail facility. The performance obligations could be interpreted to be one of:

- 1) Construction of all three buildings
- 2) Construction of each separate building
- 3) Construction of individual floors
- 4) Construction of the specific elements (i.e. façade, air conditioning or plumbing, fit out, etc.)
or
- 5) Laying each individual brick.

In practice we would view that there are three separate performance obligations with distinct risk profiles (i.e. separation of performance obligations would be level 2 above).

Requiring separation of performance obligations to the more detailed levels is of little relevance to users and will lead to:

- Arbitrary or artificial identification of performance obligations implicitly embedded within contracts for the sole purpose of meeting the requirements of an accounting standard.
- Inconsistent identification of performance obligations across similar contracts.
- Significant costs incurred to implement and maintain systems to track numerous performance obligations.
- Subjectivity in allocating the transaction price to each performance obligation.
- It is not practical or relevant for performance obligations to be separately identified to a detailed level.
- Could result in a construction contract being segmented into the potentially thousands of individual services that comprise a construction service.

As a result we believe additional guidance that allows a bundle of goods or services to be distinct, without segmentation into component parts, should be provided.

Question 3

Do you think that the proposed guidance in paragraphs 25–31 and related application 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?

We believe the definition in paragraph 26 that a customer obtains control of a good or service “when the customer has the ability to direct the use of, and receive the benefit from, the good or service” is geared toward completed goods or received services and does not address the concept of control of work in progress involved in continuous transfer of services in construction. This appears only to be considered in paragraph 30(d).

We also believe refinement of the indicators that a customer has obtained control of a good or service (or a bundle of goods or services) is required. We believe that indicator “d) the design or function of the goods or service is customer specific” is particularly persuasive in indicating control of work in progress involved in continuous transfer of services in construction. The importance of customer specific design is identified as the most important factor in relation to revenue recognition in IFRIC 15 (that is specifically mentioned in BC. 66). We believe that paragraph 31 that states “not one” of the indicators in paragraph 30 by itself should determine whether the customer has obtained control should be changed to apply to 30 (a) to (c) only.

Question 4

The boards propose that if the amount of consideration is variable, an entity should recognise 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 recognise 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 recognising revenue when the transaction price is variable and why?

We agree with this principle.

The requirement that variable consideration is recognised when reasonably estimated appears consistent with the existing IAS11, paragraph 11(b) requirements in relation to variable consideration being recognised only when “capable of being reliably measured”.

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 stand-alone 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?

This depends upon the level of at which the level of separate performance obligations are required to be identified (refer Question 2) as this will pose significant practical difficulties for construction companies.

As indicated in Question 2, the ED could result in identification of numerous distinct services provided in a construction contract. If this is the case the process of identifying stand-alone selling prices for each element would also be crippling.

If a construction contract was identified as three bundles of services with three separate performance obligations the process of identifying a stand-alone selling price for a unique project would be difficult.

The ED does not provide guidance in relation to how to determine stand alone selling prices for unique services. It merely references in ED. 51 the best evidence being the observable price “when the entity sells that good or service separately”. If the good or service is not sold separately or is not observable, for example for a completely new type of project, the entity is to estimate the stand-alone selling price. This estimation would seem to be purely academic and provide no benefit to users of financial statements and poses significant difficulty for auditors to verify the reasonableness of such estimates.

The difficulties identified above, in addition to those raised in answer to Question 2, lead us to suggest that identification of separate performance obligations in construction contracts is of little benefit for significant cost.

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 Intangible Assets or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria. Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

We believe further clarity should be provided in relation to costs incurred obtaining a contract such as engineering and design that are actually costs of fulfilling a contract. Contracts “under negotiation” are currently only mentioned briefly; see ED. 57(a).

As currently drafted interpretation can be made that all costs incurred prior to actual contract cannot be “costs incurred in fulfilling a contract” as at the time they are incurred there is no contract in place.

To enhance clarity we recommend the standard include the words from BC156 in paragraph 57 so it reads:

“If the costs of fulfilling a contract (including costs incurred as part of the process of obtaining a contract i.e. engineering and design costs) do not give rise....”.

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?

We would suggest that, similar to IFRS 8, the entity provide disclosures on timing and uncertainty of revenue and cash flows based on what detail is provided to the CODM.

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?

Leighton currently has some contracts with lives over 30 years in duration. Disclosure of amounts beyond 5 years is viewed as having little relevance to users' assessment of the current and expected performance of the business. This also recognises that the accuracy of assumptions made beyond 5 years decreases, e.g. in relation to variable consideration.

We suggest that entities be given an accounting policy choice regarding disclosure of remaining number of years of remaining performance obligations are provided, for example Leighton currently only discloses "work in hand" up to 5 years in the future. .

We also suggest that guidance be given in relation to foreign exchange rates to be used (i.e. period end rate) for contractors operating in multiple locations.

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?

Refer answer to Question 10.