

Certified Public Accountants • Business Consultants

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Technical Director
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Baden, Gage & Schroeder, LLC appreciates the opportunity to comment on the FASB's proposed Accounting Standards Update on Revenue Recognition (Topic 605): Revenue from Contracts with Customers. We are extremely interested in the Boards project on revenue recognition and it is our desire to ensure that high-quality accounting for the construction industry is maintained.

A large portion of our business, as a public accounting firm, is offering assurance services to small to midsized family owned construction companies. We are responding, not only on behalf of ourselves and our profession, but also on behalf of our clients.

We have significant concerns over how the new standard may be applied to our clients. The current guidance in the Exposure Draft for recognizing revenue at the "performance obligation" level presents significant challenges for our firm and risks our ability to effectively audit our construction industry clients stemming from an inferior method of revenue recognition. The inherent subjectivity of the prescribed process for identifying and allocating revenue to performance obligations will lead to less consistency and transparency in the financial reporting process in the industry, rather than more. Furthermore, the auditor and the management team are going to have different opinions on what a definition of performance obligation is and what continuous transfer is defined as. The inherent subjectivity opens the door to financial engineering and outright manipulation.

We request that the Board recognize that in most cases, construction activities for a given project are highly interrelated and have overall risks which are inseparable. Therefore, construction companies lack a basis for determining the price at which it would sell the components of a contract separately. In addition, we anticipate that the cost and time to audit against these new standards will increase significantly, with little inherent value to our clients. These increased costs will negatively impact our clients who are already experiencing diminished margins and workload/backlog.

With respect to determining the contract price, we believe that variable consideration (i.e. bonuses or penalties) should be excluded from the calculation of contract revenue until such time as their realization is reasonably assured. Until that time, the inclusion is highly subjective and as a matter of course, we believe that most users of financial statements will not want to see such amounts included in revenue until their realization is reasonably assured.

From our clients' perspective, we foresee that they will want to maintain a schedule of values for a job and manage jobs in the same way they currently do. The new standard will require construction companies to keep two sets of books, one for GAAP/IFRS purposes and one for management and the bonding companies. The bonding company is concerned about each individual contract as a whole since that is what is being bonded. They are not concerned with the different deliverables of each contract.

The monthly financials under this new standard would be meaningless as significant swings in revenue would happen without any significant change in the construction of a project. How will the surety and bank reconcile interim financials with year end? Additionally, with the proposed performance obligations may come wild swings in interim reporting, possible net loss situations on obligation milestones when the overall contract is profitable. Is this really the intended result?

Currently subcontractors already have difficulty in accounting for contracts as a single deliverable, much less adding complexity. The result will be financial reports that are inappropriately and ethically pushing the boundaries, such as, processing change orders by allowing for weighted probability.

In response to a few of the FASB's questions:

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?

No. It might be possible to segment additions to or deletions from the scope of work, but the revisions to the contract may be negotiated later. In the construction industry, contract modifications are a fact of life. Some change orders are to cover schedule delays, correct design flaws changes or revision, or cover additions to and/or deletions from the scope of work.

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?

In practice, an overall contract margin is achieved by adding markup on the entire contract rather than on individual components. Performance bonds look at completion of the entire contract rather than the individual components of the contracts. From the CPA perspective, this is just one more area that the client has to make a judgment, in not only how to break apart the contract, but also to break apart the revenue associated with the performance obligation. Under your proposal, we would be auditing their judgment on that. How do we audit this aspect of the contract when contracts are not written that way?

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?

No. This would require more estimates on top of estimates.

While we appreciate the Boards efforts to create a single standard to apply to virtually all industries and transactions, we maintain a belief that the key principals of the proposed standard need to be interpreted in such a way to preserve the key tenets of SOP 81-1. Otherwise, the Boards run the very real risk of creating inferior accounting rules when applied to the construction industry.

Sincerely,

Baden, Gage & Schroeder, LLC

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