



Surety Association of Canada Association Canadienne de Caution

The Voice of Surety in Canada
Représentant de la Caution au Canada

Steven D. Ness, President

October 19, 2010

Forwarded via mail and email

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Sir or Madam:

Re: Revenue Recognition from Contracts with Customers – File Reference 1820-100

Introduction/Objective

By way of introduction, the Surety Association of Canada was formed in June 1992 to act as “The Voice of Surety in Canada”. Our membership consists of major construction bonding companies who collectively account for 97% of all surety premiums written in Canada.

The board has no doubt heard from other surety firms and trade organizations that the surety underwriting process is largely an assessment of a contractor client’s credit worthiness. A very significant part of this evaluation is an in-depth analysis of the client’s financial statements. Given this reliance on comprehensive and reliable financial information, it’s an understatement to say that surety firms have a strongly vested interest in ensuring that appropriate standards for revenue recognition are applied to the auditing of a contractor’s financial statement. In that regard, the Surety Association of Canada greatly appreciates the opportunity to comment on the issues raised in Exposure Draft ED/2010/6.

Reviewing the document we note that among the primary objectives of the FASB and IASB as set out in Paragraph IN2 on page 5, is the establishment of a uniform revenue recognition standard which will “...*improve comparability of revenue recognition standards across entities, industries, jurisdictions and capital markets*”. The document then goes on to articulate its “core principle” in Paragraph 2 on page 17 citing the concept of “performance obligations” within a contract which would allow for distinct components of that contract to be segregated for revenue recognition purposes.

While the objective of one standard for all industries in all jurisdictions is laudable in theory, we respectfully suggest that the application of the principals set out in ED/2010/6 to the non-residential construction industry is impractical and ultimately unworkable. Further, we suggest that going down this road could result in serious and costly consequences for construction clients and the surety firms that bond them.

A Construction Contract is an Integrated Obligation

A construction contract represents an integrated singular obligation of the entity to the customer. It is the contract that is the stand-alone profit centre of a construction operation and when a surety issues a bond; it is for the performance of the contract in its entirety. In the construction industry, the transaction price and the Contract price are one and the same.

While a construction contract may indeed include distinct components, some of which may even generate separate and identifiable revenue streams, these “performance obligations” are inexorably linked and from a standpoint of risk and commitment cannot be separated from the contract as a whole. This is best illustrated by Change Orders which are appended to the contract during the progress of the work. Even though these are identifiable components which are typically priced independently of the original contract, once executed they form part of the entity’s obligation to the customer under that contract.

This same principle would apply to other seemingly distinct components such as the “design” portion of a design-build contract.

We are very concerned that a move toward the segmentation of contractual components into separate “performance obligations” for revenue purposes; whether under the terms outlined in paragraph 23 or otherwise, would create chaos for the non-residential construction and surety industries for the following reasons:

- 1) **Consistency/Comparability:** Surety companies, along with other creditors and investors need to know that the information presented in an audited financial statement is not only reliable, but consistent both within and without.

Critically important in the surety evaluation process is the ability to compare an entity to its peers in terms of financial performance on operations. Indeed most surety companies have invested significant resources into the development of sophisticated credit modeling systems. Segmenting contracts into performance obligations for revenue recognition purposes would render the credit models developed by sureties and other credit analysts useless. Moreover, it would become extremely difficult to make *any* meaningful comparisons of the performance of similar entities or even between the financial results of different contracts within the same financial statement.

- 2) **Objectivity:** Even with the guidelines provided in Paragraph 23 the identification of performance obligations will by their very nature be largely determined by subjective judgment. Simply put, this will diminish the reliability of the statements making them less valuable to surety companies as an evaluation tool.

We are concerned that as consistency, comparability and objectivity are diminished; the impact on construction and surety industries will be profound and include a number of unintended consequences. We are particularly concerned about the potentially adverse effects on small to mid-sized construction firms.

Under the new standards, sureties will be forced to develop new systems and acquire additional information to allow them to undertake meaningful comparisons of peer firms and make proper underwriting decisions. Construction firms will face a particularly cumbersome and costly burden. In addition to the requirement of setting up an accounting system to produce financial statements in compliance with the new standards, they

will be forced to maintain a parallel system to meet their surety's requirements and ensure continued bonding support.

This will not present a serious problem to large, multi-national organizations with deep pockets and extensive administrative capabilities. However, the vast majority of construction firms are small to mid-sized firms with limited resources who may be unable to meet these demands. Without the ability to meet the surety's requirements, these smaller operators may find their bonding facility curtailed or even terminated. This would be devastating to a contractor's ability to compete for work in their marketplace.

Percentage of Completion vs Performance Obligation

In North America, the revenue recognition standard most commonly embraced is the *Percentage of Completion* method where revenue is recognized as the work progresses over the life of the entire contract in proportion to the degree of completion. Ideally, the recognition of revenue and profits is related to the costs incurred in providing the services required under the contract.

The board is undoubtedly familiar with a number of authoritative publications which set out detailed guidelines for the use of the percentage of completion method. We have included as attachments to this submission three relevant documents:

- 1) The Canadian Institute of Chartered Accountants Emerging Issues Abstract 78
- 2) The Surety Association of Canada's Position Paper PP017.
- 3) From the United States, AICPA's Statement of Position 81-1

We submit that the percentage of completion method while not perfect is the approach that best reflects the economic and operational realities of the non-residential construction industry.

- As it is based on tangible, identifiable numbers such as the contract price and cost-to-date, it provides a far more objective and valid assessment of the entity's revenue position.
- It allows for a continuous recognition of revenue throughout the life of the contract.
- It produces consistent and comparable data allowing sureties to make comparisons through the use of credit modeling.
- It is recognized and accepted by creditors, investors and tax authorities.

We recommend that in applying the percentage of completion method as a standard, the board may consider providing guidance on the manner in which it should be applied. For example, the most commonly used approach is the "cost-to-cost" method which compares the total costs incurred to date to the total anticipated costs. A less reliable measuring stick would be "billings to date" which is often has no relationship to the actual degree of completion of the project.

The Transfer of Control Issue

The draft proposes that revenue be recognized only upon the satisfaction of the performance obligation which takes place "...when the customer obtains control of that good or service". Control is then defined as "when the customer has the ability to direct the use of and receive benefits from the good or service".

Given the nature of construction transactions, this would seem to indicate that under the proposed standard

revenue may only be recognized by using the completed contract method. The draft does provide some measure of clarification in Paragraphs 32 and 33 when it allows for “continuous transfer of goods or services”. However, the guidance provided is ambiguous at best and at times confusing and misleading.

This is compounded by the issues that may arise from legal interpretations of “control” of a project or job site. For example, in Canada most provincial jurisdictions deem the contracting firm to be in control of the site for purposes of environmental assessments, liability, etc. Control of the *asset* may not be the same as control of the *project*

If the proposed standard is to incorporate the concept of customer control, it should ensure that this matter is clarified and that an appropriate definition is in place to recognize the continuous transfer of the construction asset and unambiguously allow for percentage of completion accounting

Responses to Questions

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. Do you agree with this principle? If not, what principle would you specify for identifying separate performance obligations and why?*

As discussed above, the contract is the obligation undertaken by the entity to the customer and it is the performance of that contract that is guaranteed by a surety company under its bond. Components of that contract; even those that are “distinct” in character and generate their own revenue streams are an integral part of that obligation. As applied to the construction industry, we see no benefit to segmenting the contract into performance obligations and believe that the standard should be that unless exceptional circumstances present themselves, the construction contract should be the single performance obligation.

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?*

The guidance is ambiguous and confusing. If the concept of customer control is to be retained, more clarification is required to ensure flexibility and allow for other methods of revenue recognition.

Question 5: *Paragraph 43 proposes that the transaction price should reflect the customer’s credit risk if its effects on the transaction price can be reasonably estimated. Do you agree that the customer’s credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?*

And

Question 6: *Paragraphs 44 and 45 propose that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit). Do you agree? If not, why?*

In a construction transaction, the contract price and the transaction price should be one and the same. This is most often arrived at from the entity's bid to the customer and may be adjusted by change orders or other negotiations. When a contracting entity prepares and submits a bid, it will incorporate an allowance for uncertainties and risk items such as financing cost, incentives, penalties, credit risk, etc. Any attempt to tie allowances for these uncertainties to the recognition of the revenue should be rejected as a) risk factors have already been accounted for and b) to do so would add yet another layer of subjectivity to the calculation of revenue which would further diminish the value of the statement.

Question 13: *Do you think that an entity should apply the proposed requirements retrospectively (i.e. as if the entity had always applied the requirements to all contracts in existence during any reporting periods presented)? If not, why?*

No. Restating prior years' statements under the new standard would increase cost and administrative burden to the entity without provide a commensurate benefit to users of the statement.

Question 15: *Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?*

As is the case with other risk elements discussed in the responses to Questions 5 and 6, costs for warranty servicing is built into the bid submitted at time of tender which becomes the contract (transaction) price.

Conclusion and Recommendations

In light of the discussion above, we respectfully submit for your consideration the following recommendations:

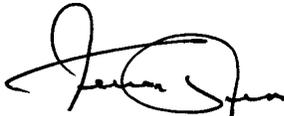
- Incorporation of the principles, guidance and language included in the aforementioned publications; EC 78 and SOP 81-1 which will.
 - Encourage the use of the cost based percentage of completion method in most cases unless other approaches would be more appropriate.
 - Treat the construction contract as the singular performance obligation where the contract price becomes the transaction price.
- Avoidance of standards or approaches which lead to uncertainty such as the use of billings based approach for determining percentage of completion.
- Avoidance where possible of standards that rely heavily on subjective evaluations; e.g. weighting of credit risk, potential penalties, etc.
- Requirement for a clearly articulated and detailed description of the revenue recognition policy in the notes to the financial statement.
- No requirement for retrospective implementation.

As discussed in our Position Paper PP017, the Surety Association of Canada strongly supports the application of standards that provide for consistent comprehensive and transparent financial information. Like most of our colleagues in the surety industry, we support the use of the cost based percentage of completion method in most cases but will also support the flexibility to employ other approaches when circumstances require.

Again, while we appreciate and understand the motivation to reconcile the revenue requirements of GAAP with those set out in IFRS, we are concerned that the uniqueness of industries such as non-residential construction may be overlooked in a one-size-fits-all approach. Again, we urge the boards to ensure that the adopted standards produce financial statements that are consistent, comparable, clear and objective.

Again, we thank the boards for the opportunity to provide our comments and would be happy to elaborate on any of the points discussed herein.

Yours Very Truly,

A handwritten signature in black ink, appearing to read "Steven D. Ness". The signature is stylized with a large, looping initial "S" and a long horizontal stroke extending to the left.

Steven D. Ness
President,
Surety Association of Canada



SAC Position Paper – PP017

Reporting of Revenue on a Contractor's Financial Statement

Surety companies often encounter a serious problem in the reporting of revenue on a contractor's financial statements. Imprecise reporting standards have led to serious discrepancies in revenue recognition and in many cases; the contractor's profitability is materially misstated. It is the position of the Surety Association of Canada that revenue should be recognized using the "percentage of completion" method as determined by comparing cost-to-date to estimated total cost of the project.

Surety companies have long been aware of a serious problem in the reporting of revenue for construction contractors in Canada. The association believes that the problem can be traced to directions provided in the C.I.C.A. Handbook which are sufficiently vague as to allow a wide variety of interpretations and may lead to the provision of financial information which is misleading.

We refer in particular to **Section 3400** which deals with the issue of revenue recognition. **Section 3400** offers the following definitions for the Percentage of Completion Method:

A method of accounting that recognizes revenue proportionately with the degree of completion of goods or services under contract.

With respect to construction contracts and other long term obligations, **Paragraph 3400.08** attempts to place a finer point on the definition by stating:

In the case of rendering services and long-term contracts, performance should be determined by using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.

While this seems appropriate enough as a general guideline, its value as a working directive to accounting practitioners in the construction industry is questionable. Specifically, we believe that the accounting standards do not provide enough guidance as to the way in which the percentage of completion method should be applied, and that using billings-to date as a measure of completion may be inappropriate for revenue recognition purposes. Industry experience indicates that contractors and their accountants frequently focus on billings-to date to determine a project's progress. This approach usually has the effect of front ending profit recognition and can materially distort the true profit based on a proper matching of costs and revenue.

This is not an issue of simple non-compliance. In discussing the issue with C.A.'s who offer such audit opinions it appears that they truly believe that they are in full compliance with **Section 3400** as written. Reviewing the language used in **paragraph 3400.08** this assertion would seem to have merit. Indeed a reasonable individual can conclude that "reasonable assurance" as to performance exists when a customer or their representative (architect or consulting engineer) approves the contractor's invoice for payment, notwithstanding that such an approach can seriously distort a contractor's financial picture.

To illustrate the nature of the dilemma, consider XYZ Construction Ltd. which at its fiscal year end had one job in progress as shown:

XYZ Construction Ltd.

Job	Contract Price	Cost	Original	To Date		Remaining Costs to Complete
			Estimated Profit	Billings	Costs	
1	\$1,600,000	\$1,400,000	\$200,000	\$1,000,000	\$750,000	\$750,000

Employing the “**Cost-to-Cost Percentage of Completion Method**”, the job is 50% complete at year end and has generated revenue of \$800,000 with a gross profit of \$50,000. The balance sheet will include a \$200,000 allowance for “Billings in Excess of Costs and Estimated Earnings” shown as a current liability.

By contrast, the” **Billings-to-Contract Price Percentage of Completion Method**” will yield a different and a slightly distorted revenue picture. Using this method, the job is 62.5% complete at year end and has generated revenue of \$1 million with an earned gross profit of \$62,500; \$12,500 more than would be earned under the cost-to-cost method. Using this method, \$188,000 would appear as a current liability on the balance sheet to reflect the amount “over billed” to the project owner. If a project is over-billed, this method of revenue recognition will result in profits being earned quicker than the cost-to-cost method. Alternatively, if a project is under-billed profits will be earned slower than the cost-to-cost method. In the end, both methods of revenue recognition will converge to an identical earned profit amount once the project has been completed.

An even more distorted picture emerges when the “**Pure Progress Billings Method**” is applied. Under this method, revenue is recognized at the moment the invoice is submitted to the project owner with no regard to the true extent of completion of the physical work nor any balance sheet allowances for overbilling. Revenue is now \$1.0 million with \$250,000 in gross profit, despite the fact that as the job proceeds to completion, the lion’s share of these “profits” will disappear to arrive at a final gross profit of \$100,000.

Field experience suggests that the practice of using billings-to-date as a measure of project completion is widespread. During the course of earlier discussions with C.I.C.A., the Surety Association of Canada contacted underwriters from the largest bonding firms in the industry. These underwriters were asked to choose ten files at random with statements purportedly prepared on the percentage of completion basis. On average less than 50% were actually prepared using the **Cost to Cost Percentage of Completion Method**.. Most were prepared under the **Billings to Contract Price Percentage of Completion Method** method and some even using the **Pure Progress Billings Method**.

.While many accounting firms have their own more detailed guidance and many make use of other authoritative literature (e.g. Skinner - *Accounting Standards in Evolution* and The A.I.C.P.A. *Auditing and Accounting Guide for Construction Contractors* in particular), many it seems do not. To its credit, C.I.C.A. has recognized the seriousness of this dilemma. In January 1997, The Emerging Issues Committee published *EIC-78 Construction Contractors – Revenue Recognition When the Percentage Completion Method is Applicable*. This abstract articulated the problem in more detail and directed practitioners’ attention to the authoritative sources mentioned above. Despite this laudable effort however, surety personnel continue to observe a preponderance of financial statements which purport to be prepared under the percentage of completion method, but are in fact using some variation of a billings/accrual basis of revenue recognition

The Surety Association of Canada urges contractors and accounting professionals to adopt the revenue recognition method that most accurately reflects the measure of completion of projects in progress. We suggest that in the majority of cases this will be the *Cost to Cost Percentage of Completion Method*. We believe as well that revenue recognition methods that distort the true profit picture such as the *Pure Progress Billings Method* should be avoided.

Finally, the Surety Association of Canada believes that the establishment and enforcement of a more thorough approach to recognition of construction revenue is in the interest of all parties. In that regard, the following suggestions are offered:

- Accountants provide a clearly articulated and detailed description of the revenue recognition policy in the notes to the financial statement.
- A schedule should be included with the financial statement which details the status of each job in progress at the statement date. Such schedule should include:
 - Revised Contract Price including any and all approved change orders.
 - The original estimate of job cost and gross profit.
 - Amount invoiced to the client.
 - Total job cost to date.
 - Estimated cost to complete.
- A second schedule which details the status of jobs completed during the fiscal period. This schedule should include:
 - Final contract price
 - Final job cost and gross profit
 - Job costs incurred and gross profit earned during prior fiscal period(s)
 - Job costs incurred and gross profit earned during the current fiscal period
- Appropriate balance sheet treatment of over and under billings where applicable. The amounts shown on the balance sheet should be easily identifiable from an analysis of the two schedules discussed above.

To operate effectively in today's competitive marketplace, a contractor needs a healthy relationship with their surety, bank and other creditors. Detailed and thorough financial information with appropriate treatment of revenue recognition will enhance a surety's confidence in a contractor's operation and will go a long way toward helping the firm meet its business objectives.

For More information, readers are encouraged to visit the Surety Association of Canada website at www.surety-canada.com, or contact the association directly:

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Email: surety@surety-canada.com

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.