1820-100
Comment Letter No. 482

Covering The Carolinas

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Financial Accounting Standards Board
Attn: Technical Director - File Reference No. 1820-100
401 Merritt 7
Post Office Box 5116
Norwalk, CT 06856-5116

Dear Sirs:

Smith, Kesler & Company, P.A. is pleased to provide our response to your exposure draft on revenue recognition. Smith, Kesler & Company, P.A. is a public accounting firm with 95% of our clients in the construction industry, and all are privately held. We work closely with our clients and the surety industry to provide timely and useful financial statements.

Although adopting a single and consistent standard for revenue recognition may seem reasonable, we do not believe this is feasible given the unique aspects of revenue recognition in the construction industry as compared to other industries where revenue recognition is not as complex. One size does not fit all. There are numerous complexities and ever changing conditions on almost every construction contract.

The goal of the exposure draft is to achieve greater consistency in revenue recognition across all industries. Adoption of these standards will not achieve that goal INSIDE the construction industry, and we believe that it will actually result in greater inconsistency, which will lead to less credibility. In the exposure draft, there is tremendous room for subjectivity (and its corresponding inconsistency) regarding the definition of a "performance obligation", the satisfaction of a performance obligation, the measurement of the transaction price (stand alone pricing?), and the re-measurement of these items. The abstract definitions will lead to inconsistent reporting across the construction industry and will eventually lead to lowering the credibility of the financial statements to the third-party users.

The guidance under this exposure draft enhances the opportunity and ability of management to distort income. Contracts can be arbitrarily and subjectively broken into various performance obligations with pricing and profits arbitrarily and subjectively assigned to each one. Savvy contractors/CFOs/controllers can easily put the profits in the performance obligations wherever they want and recognize them when they desire, early or late in the performance of the contract. Since they are highly subjective, it will be difficult (and expensive) to test or challenge them.

Given the same scenario, a group of five ethical accountants or members of management, (with no desire to distort results) would arrive at five very different and very inconsistent results under the proposed standards. Using the current standards (ASC 605-35 / SOP 81-1), their results would be far more consistent.

Cost to the contactor is another important issue. Many smaller contractors do not have the accounting systems or the personnel that would be capable of capturing the data necessary to report under these standards of splitting up contracts into performance obligations. The increased costs of software and other costs necessary to comply with generally accepted accounting principles would be rather high and unwelcome given the current economic hardship being faced in the construction industry.

The changes to the current revenue recognition standards for long-term contracts will also cause an unpopular increase in accounting fees. Along with the increased cost of analyzing each contract broken down into a number of separate performance obligations, they will have the increased cost of complying with IRS tax regulations along with these new standards for their financial statements. The IRS requires the use of the percentage of completion method for many contractors. One contract schedule works for both the financial statement reporting and the tax return reporting, with minor modifications for loss contracts under the current standards. Under the proposed standards, they will need separate and potentially very different contract schedules for each. So, is there really a cost benefit to be derived from these changes?

While we respect the effort to merge U.S. and international standards, the small and mid-sized contractors are not concerned about this issue. They are concerned with getting a bond on a contract they are bidding next week here in the United States, not if their financial statements are comparable to contractors in Europe or Asia.

Perhaps the most important aspect of the pending change is the concern of the third-party users with the financial statements, primarily the surety industry. They should be the focus driving the changes to the current standards that will affect the construction industry. Will these proposed changes be useful and credible to them? According to discussions with members of the surety industry, strong potential exists that they will still want to see statements presented under the current standards. They want to see income recognized ratably over the whole contract, regardless if this exposure draft becomes effective. They are very concerned about the subjectivity of recognizing income. If the users of the financial statements might require what will be a non-GAAP presentation, then we believe we will have taken a step backwards.

For example, let's assume there are identical $100,000 contracts which will have a cost of $60,000 when completed. Cumulative cost at the end of the reporting period is $30,000.

Contractor A has identified 3 distinct performance obligations and has assigned the stand alone selling price as follows:

Performance Obligation 1 - $50,000 with $35,000 of cost for a $15,000 profit
Performance Obligation 2 - $25,000 with $15,000 of cost for a $10,000 profit
Performance Obligation 3 - $25,000 with $10,000 of cost for a $15,000 profit
As $30,000 has been spent on #1, it is not complete; no revenue or profit is recognized.

Contractor B has identified 5 distinct performance obligations, is self-performing the work at the beginning of the project, and has subcontracted the work at the end. Stand alone selling prices are as follows:

Performance Obligation 1 - $20,000 with $10,000 of cost for a $10,000 profit
Performance Obligation 2 - $10,000 with $5,000 of cost for a $5,000 profit
Performance Obligation 3 - $30,000 with $10,000 of cost for a $20,000 profit
Performance Obligation 4 - $20,000 with $15,000 of cost for a $5,000 profit
Performance Obligation 5 - $20,000 with $20,000 of cost for no profit
As $30,000 has been spent and the first three performance obligations have been completed, revenues of $60,000 and profit of $35,000 are recognized.

Contractor C is the same as B; however, they have subcontracted the beginning of the project and are self-performing the work at the end. Stand alone selling prices are as follows:

Performance Obligation 1 - $20,000 with $20,000 of cost for no profit
Performance Obligation 2 - $10,000 with $10,000 of cost for no profit
Performance Obligation 3 - $30,000 with $20,000 of cost for a $10,000 profit
Performance Obligation 4 - $20,000 with $5,000 of cost for a $15,000 profit
Performance Obligation 5 - $20,000 with $5,000 of cost for a $15,000 profit
As $30,000 has been spent and the first two performance obligations have been completed, revenues of $30,000 and profit of $-0- are recognized.

Contractor D assumes the contract is the performance obligation and that there is a continuous transfer, allowing for ratably recognizing income over the contract. They use the output method as recommended in paragraph 33(a) of the exposure draft. It is estimated that based on output, the project is 30% complete. Revenues of $30,000 and profit of $12,000 are recognized.

Contractor E also assumes the contract is the performance obligation and that there is a continuous transfer, allowing for ratably recognizing income over the contract. They use the input method as in paragraph 33(b) of the exposure draft, the closest method to the current way. As there has been $30,000 spent on the project, it is 50% complete. Revenues of $50,000 and profit of $20,000 are recognized.

All of the foregoing results would be allowable under the guidance in the exposure draft, and five very different financial statements would be produced. How can this be useful to a third-party user trying to compare the five contractors doing identical jobs but reported five different ways? Would they not want to see it reported the same way by all contractors? They need useful statements that they can easily analyze to make their decisions. Throwing variety into the mix makes that process that much more difficult. They do not need the added burden of analyzing how the contractor reports income and how that is different from other contractors.

We could make arguments why all of the foregoing are the best way (except for A which we feel is completely misleading.) Theoretically, B and C are the truest picture of what is actually happening. So why is E the best choice? Because it equalizes A, B, C and D, there is no room for subjectivity, it eliminates inconsistency, and is easily understandable by the contractors and the third-party users without additional explanation. Had A-E been required to use the current method, they would have identical and consistent statements.

The current guidance has been in place for over two decades. While it may need improvement in certain areas, we believe it produces consistent and accurate results. Theoretically, assuming that the current standards do produce accurate results, the proposed guidelines SHOULD produce similarly accurate results. If this is true, then what is cost benefit to be derived from going through all these changes to arrive at the same result?

The following addresses specific questions posed in the exposure draft:

<u>Question 2</u>: *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?*

With limited exception, the contract should be the performance obligation. Any contract can be broken down into separate items that would meet the definition of a performance obligation. For example, a building has many components. All of which can be sold separately, have a distinct function, and a distinct profit margin. This will lead to some entities reporting

the whole contract as the performance obligation and some having many performance obligations in one contract. Both views are entirely reasonable under different interpretations of the definition of a performance obligation. Having two entities report the same contract differently is inherently inconsistent. The contract as a whole should be the performance obligation, and income should be recognized ratably over it.

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 determined?*

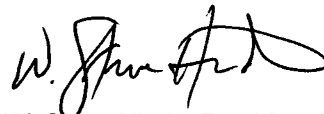
Again the contract should be the performance obligation and the contract price is the standalone selling price. Having the contract split up into multiple performance obligations and assigned a very subjective stand alone selling price and recognizing that revenue when the performance obligation is complete will lead to inconsistent reporting of identical contracts as compared to everyone using the contract as the performance obligation and the contract amount as the stand alone selling price.

Question 18: *Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations)? If so, which requirement(s) and why?*

Yes, nonpublic entities should be exempt from using these requirements. As previously mentioned, the high cost to the contractors (and the third-party users of their financial statements) of implementing these changes has no benefit to them and is an unnecessary burden to them.

In conclusion, we would urge you to consider the profound effect of these potential changes to the construction industry when making your decisions and would recommend that you either exempt the construction industry and/or nonpublic entities and keep the current standards or incorporate more of the current standards into the proposed guidelines and remove the subjectivity that will lead to inconsistency.

Sincerely,



W. Steve Hinds, President
Smith, Kesler & Company, P.A.

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