ASSOCIATION OF SINGAPORE MARINE INDUSTRIES (ASMI)

ASMI'S COMMENTS TO EXPOSURE DRAFT ON REVENUE FROM CONTRACTS WITH CUSTOMERS (ED/2011/6)

PREAMBLE

- 1 The Association of Singapore Marine Industries (ASMI) is a non-profit trade organisation representing the Marine and Offshore Engineering Industry in Singapore. Its members are shipyards and marine companies in the business of oil rig building and repair, ship building, ship conversion and repair. Singapore is the global leader in the building of jack-up drilling rigs and conversion of floating production storage and offloading (FPSO) vessels. It is also a major ship repair and conversion centre and builder of semi-submersible rigs and platforms.
- 2 The duration of the industry's projects typically range from a few months to a few years. A rig building project will take between 18 to 36 months to complete. Our rigbuilding projects include jack-up and semi-submersible rigs and offshore production platforms. In a rig building and ship building contract, the transfer of the good, which is the new oil rig, platform or ship built, will take place on the completion of the contract.
- Our Industry members currently use the Percentage of Completion (POC) method for revenue recognition. They are concerned that the form of the proposed standard may result in them having to account for projects under the Completed Contract Method (CCM).
- Our members opined that the proposed Revenue Recognition standard is directed at generic application across industries and might not have taken into consideration the uniqueness of the nature of goods or services transacted in the marine and offshore engineering industry. Our projects are highly specialised.
- Industry members feel that the POC method is a more reasonable and suitable method of revenue recognition for the marine and offshore engineering industry, given the nature of the goods or services delivered by the industry and duration of the projects.
- Revenue recognition based on CCM only will affect the periodic financial performance and business performance reporting of our companies. It will also have impact on staff performance bonus and company's dividend payments as well as the stock markets since many of our industry members are listed companies. It may change the way our companies do business in Singapore and our commercial practices and accounting process.
- 7 If revenue cannot be booked progressively for work completed but only when the project is completed 18 to 24 months from project commencement, there will be long period of zero reported revenue which will not reflect the economic substance of the underlying transactions.

INDUSTRY'S COMMENTS AND QUERIES FOR IASB'S CLARIFICATION

We have tabled below the industry's comments and queries on the questions raised in Clause IN38 of Exposure Draft on Revenue from Contracts with Customers (ED/2011/6).

Question 1: Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognises revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

Comments: There should be more clarity on how to evaluate whether an asset has an alternative use to the entity. We view that in a rig building or shipbuilding contract, the new rig or vessel is built to selected design incorporating customer's specifications and requirements, hence each rig or vessel built is a 'unique' item. However, in the event of termination of contract by the original customer, while resources are expended to look for other customers and find a suitable match, this may or may not result in significant costs and time to be incurred to resell the product. The extent of the costs and how readily the asset can be redirected to another customer depends on whether another customer can compromise by accepting the asset without further customisation and whether we are able to market it to our existing customers.

> It is also not clear whether the significant cost criterion is determined based on the percentage of contract value. If so, it will be difficult to justify that costs incurred for a rig building project that typically sold for over US\$400 million is significant as compared to an asset that is sold for less than US\$10 million.

> It is also not clear under paragraph 35(b)(ii) how another entity need not substantially re-perform the work the entity has completed to date if the benefit of the asset presently controlled by the entity (work-in-progress) is not transferred to the former.

> The criterion under paragraph 35(b)(iii) needs to be more specific and practical as typically, an entity will only be compensated for the work performed to date in the event of default by the customer and not applicable to default by the entity. In the event of termination of a contract as a result of non-performance by the entity, the customer can reject the work performed and request for refund of consideration paid to date and seek compensation instead of the customer compensating the entity for the work performed to date.

Question 2: Paragraphs 68 and 69 state that an entity would apply IFRS 9 (or IAS 39, if the entity has not yet adopted IFRS 9) or ASC Topic 310 to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

Comments:

The current practice in the marine and offshore engineering industry in Singapore is to treat any receivable that is assessed to be uncollectible because of a customer's credit risk as operating cost. Presenting as a separate line item adjacent to the revenue line item will result in a mismatch where revenue is recognised in the previous year, but impairment of the receivable is made in the current year. For an entity which has revenue deriving from a single contract, it could result in negative revenue for the year.

This change will have a significant effect on our income statement and gross margins. The credit risk might even be related to a prior period transaction and will result in a mismatch with the revenue recognised for the period. In the event that there is zero revenue for the period, a credit risk adjustment will reflect a net negative income for the period which is very misleading.

Question 3: Paragraph 81 states that if the amount of consideration to which an entity will be entitled is variable, the cumulative amount of revenue the entity recognises to date should not exceed the amount to which the entity is reasonably assured to be entitled. An entity is reasonably assured to be entitled to the amount allocated to satisfied performance obligations only if the entity has experience with similar

performance obligations and that experience is predictive of the amount of consideration to which the entity will be entitled. Paragraph 82 lists indicators of when an entity's experience may not be predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations. Do you agree with the proposed constraint on the amount of revenue that an entity would recognise for satisfied performance obligations? If not, what alternative constraint do you recommend and why?

Comments: No comments.

Question 4: For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognise a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

Comments: No comments.

Question 5: The boards propose to amend IAS 34 and ASC Topic 270 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial reports.* The disclosures that would be required (if material) are:

- The disaggregation of revenue (paragraphs 114 and 115)
- A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- An analysis of the entity's remaining performance obligations (paragraphs 119–121)
- Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)
- A tabular reconciliation of the movements of the assets recognised from the costs to obtain or fulfil a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial reports? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial reports.

Comments: No comments.

Question 6: For the transfer of a non-financial asset that is not an output of an entity's ordinary activities (for example, property, plant and equipment within the scope of IAS 16 or IAS 40, or ASC Topic 360), the boards propose amending other standards to require that an entity apply (a) the proposed requirements on control to determine when to derecognise the asset, and (b) the proposed measurement requirements to determine the amount of gain or loss to recognise upon derecognition of the asset.* Do you agree that an entity should apply the proposed control and measurement requirements to account for the transfer of non-financial assets that are not an output of an entity's ordinary activities? If not, what alternative do you recommend and why?

Comments: No comments.

ADDITIONAL COMMENTS AND QUERIES FROM INDUSTRY

1 Identifying Separate Performance Obligations

a) Variation Orders

In rig building, ship building and ship conversion contracts, the ultimate product to be delivered to the customer is the newly constructed or converted vessel or rig. This can only be done on the full completion of the contract.

In the marine and offshore engineering industry, it is common to have Variation Orders ("VO"). Very often, a single project may have more than one VO. In the case of rig building, VOs are changes to the specifications from the original contract. We will view VOs as part of the original/base contract as they are related to the original contract and should be considered as one integral performance obligation.

Para 29 of the ED states that an entity shall account for the bundle as a single performance obligation if the goods or services in the bundle are **highly** interrelated and the bundle of goods or services is **significantly** modified or customised to fulfil the contract.

We urge the IASB to provide more clarification on what "highly interrelated" and "significantly modified" entails and whether we can view VOs as one performance obligation with the main contract.

2 Determining the Transaction Price

a) Time Value of Money

Para 58 of the ED states that an entity shall adjust the promised amount of consideration to reflect the time value of money if the contract has a financing component that is significant to the contract.

In rig building contracts, there are projects with 20-80 payment arrangement whereby customers pay 20% on contract signing and balance 80% on completion and delivery. It is not clear in the current ED on whether such arrangements would be seen as having a significant financing component.

Taking into account the fact that such payment arrangements are typically industry/market practices, do we need to consider them as having a significant financing component? Again, it may be good for the IASB to provide more guidance on what 'significant' entails.

b) Transfer of Goods or Services

It is not clear in paragraph 60 on what constitutes "transfer of the promised goods or services to the customer will be one year or less". A transfer could refer to delivery of the promised goods or it could mean transfer of control as under paragraph 35(b). In a rigbuilding or shipbuilding contract where 20% is collected upon contract signing and 80% collected upon delivery, it can be interpreted that there is no time value of money to be accounted for in view that the promised consideration of 80% of the contract value will be collected when we deliver the rig/ship to the customer. It can also be interpreted that there is time value of money since transfer of control can take place when the project is 50% completed but collection of 80% of the contract value only takes place more than a year later.

It is our interpretation that if the 20% is received on contract signing and not after 12 months of signing it does not have a component of financing. Similarly for the period until completion and delivery the 80%, if received upon delivery, should not be regarded as

having a component of financing, unless the 80% is received more than 12 months after delivery. Is this interpretation correct?

c) Credit Risk

Under the proposed ED/2011/6, credit risk is to be presented in profit or loss account as a separate line item adjacent to the revenue line item. This will have an impact on the gross margins of the companies. It is often the case that credit risk recognised relates to a sale transaction in the prior periods and hence causing a mismatch. In the event that there is nil revenue for the period, a credit risk adjustment will result in a negative margin for the company which could be misleading.

We urge the Board to keep the current disclosure method of presenting credit risk (i.e. doubtful debt provision) as an operating expense.

3 Satisfaction of Performance Obligations over time – Percentage of Completion method (POC)

a) Alternative use

Para 35(b) of the ED states that an entity can recognise revenue over time if the entity does not create an asset with an alternative use to the entity and at least one of the criteria in Para 35(b)(i) to Para 35(b)(iii) is met.

Clause 36 states that "A promised asset would not have an alternative use to an entity if the entity is unable, either contractually or practically, to readily direct the asset to another customer". It further states that "the asset would not have an alternative use if the contract has substantive terms that preclude the entity from directing the asset to another customer or if the entity would incur significant costs to direct the asset to another customer".

What is meant by "ability to readily direct"? In a rig building or shipbuilding contract, the new rig or vessel is built to selected design incorporating customer's specifications and requirements. Hence, each rig or vessel built is a 'unique' item. The transfer of such an asset (the rig or vessel) to another customer (in the case of termination of contract by the original customer) can only take place after substantial resources are expended to look for other customers to find a suitable match. In such a scenario, additional customisation for the new customer is typically required. It is also possible for the entity to sell a half-completed asset to another customer with a reduction in price.

Based on the above, we would interpret the new rig or vessel as not having an alternative use. To provide better clarity, we would like to suggest the IASB to give an illustrative example specific to the Marine and Offshore Industry and to also provide more guidance on what "significant costs to direct the asset" includes. In the case where an entity sells a half-completed asset with a reduction in price, will that be considered as "significant costs to direct the asset"?

b) Right to payment for performance completed to date

For our industry, in the case of customer default, we can typically sue the customer to get compensation for the work done to date. We are of the view that the right to sue represents a right to payment for performance completed to date.

We also propose that the IASB can consider adding <u>customer acceptance</u> as another criteria. It is common practice in the industry for owner's representative to be stationed in the yard to monitor and control the progress of the work. Progress meetings and acceptance of work as it progresses are acknowledged by the owner's representatives.

We feel that such progressive acceptance is an indication of performance obligation being satisfied over time.

In rig/ship construction, an early termination will result in the shipyard and customer taking quite some time to contractually and practically resolve the settlement and claims issues. Thus for an incomplete vessel it is not possible to readily direct. We interpret that under such circumstances the entity does not have an alternative use for the promised asset. Is this interpretation correct?

CONCLUSION

- 1. Our industry members are of the view that a contracted rig and/or vessel will be able to meet the definition of having "no alternative use" and also satisfy Para 35(b)(iii) as we have the right to sue in the event of customer default. Hence, we are of the view that we can continue to use the POC method to recognise revenue progressively.
- 2. We strongly feel that the POC method is a more reasonable and suitable method of revenue recognition for the marine and offshore industry, given the nature of the goods or services delivered by the industry and duration of the projects.

Prepared by: ASMI Secretariat

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