March 12, 2012

Via U.S. Mail and Electronic Mail

Technical Director
File Reference No. 2011-230
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Exposure Draft
Proposed Accounting Standards Update (Revised)
Revenue from Contract with Customers
File Reference No. 2011-230

The Surety & Fidelity Association of America (“SFAA”) is a trade association of approximately 450 insurance companies that are licensed to provide surety and fidelity bonds. SFAA member companies collectively provide the vast majority of performance bonds and payment bonds in the United States. We appreciate the opportunity to submit comments regarding the captioned Exposure Draft issued by the Financial Accounting Standards Board (“FASB”) (2011 Draft). It appears that many of our concerns that we expressed in our letter dated October 21, 2010, in response to the initial release of the Exposure Draft, have been addressed. However, we have a few concerns and recommendations regarding the 2011 Draft.

As we noted in our October 21, 2010, letter, a performance bond secures a contractor’s obligation to perform fully the construction contract. A payment bond secures the contractor’s obligation to pay its subcontractors and suppliers. In underwriting a contractor to determine whether to provide performance and payment bonds for a given project, the surety evaluates the contractor’s financial ability to support the project and its entire operation. Therefore, sureties are significant users of financial statements. We advised that our primary concern regarding the Exposure Draft released on June 24, 2010 (“2010 Draft”) involved how accounting for revenue from construction contracts would be affected by the concept of a “performance obligation” and the concept of recognizing revenue when the performance obligation is satisfied.

Our concerns were premised on three points regarding accounting for construction contracts:
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- The construction contract is the profit center for the contractor. That is, the construction contract is the source from which revenues and profits are generated.
- As a user of financial statements, the surety is interested in how the contractor performs with respect to each contract, in its entirety. The measure of performance is the amount of profit generated by the contract and the ability of the contractor to produce the profit that was estimated at the inception of the contract.
- A project owner pays the contractor as the contractor progresses, and profits from a construction contract are generated by the activity of the contractor on the project. Costs are an objective and reliable way to account for the contractor’s progress and activities.

In light of these points, the long held view maintained by Subtopic 605-35 (“Revenue Recognition – Construction-Type and Production-Type Contracts”) has been that the percentage of completion method of accounting (recognizing revenue as costs are incurred) is the most reliable and accurate depiction of the transaction. We were concerned that the 2010 Draft would threaten the use of the percentage of completion method.

The 2010 Draft seemed to suggest that a construction contract would be divided into separate performance obligations (site work, demolition, foundation, etc.), making the accounting cumbersome, confusing and of little informational value. The 2011 Draft clarifies that separate goods and services are to be considered a single performance obligation if they are not distinct. Paragraph 29 of the 2011 Draft states that a good or service in a bundle of goods and service is not distinct and shall be considered a single performance obligation if the goods and services are interrelated and the bundle is “significantly modified to fulfill the contract.” Paragraph IG 62 provides a construction contract to illustrate this concept.

The 2010 Draft also created the concern that the revised standard required that revenue under a construction contract be recognized only when the full performance obligation was satisfied (i.e. when the contract was completed). Paragraph 35 of the 2011 Draft states that fulfillment of the obligation is satisfied over time (and thus revenue is recognized over time) when at least one of the following two criteria is met:

1. The entity’s performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
2. The entity’s performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:
   (a) The customer simultaneously receives and consumes the benefits of the entity’s performance as the entity performs.
   (b) Another entity would not need to substantially reperform the work the entity has completed to date if that other entity were to fulfill the remaining obligation to the customer.
   (c) The entity has a right to payment for performance completed to date and it expects to fulfill the contract as promised.
The example in Paragraph IG62 uses a construction contract to illustrate the concept of recognizing fulfillment of performance over time. (Section 605-10-55-79 of the revised Accounting Standards Codification presents an example of accounting for a construction contract and states, “Revenue for the performance obligation would be recognized over time by selecting an appropriate measure of progress toward complete satisfaction of the performance obligation . . . ”) Under Paragraph 44, costs incurred may be an acceptable way to measure performance over time.

Thus, some elements of the percentage of completion method of accounting for construction contracts appear to be maintained under the 2011 Draft. However, Subtopic 605-35, which sets forth the percentage of completion process also addressed the accounting of costs for each contract to compute the contract’s gross profit. It does not appear that the 2011 Draft addresses accounting for costs in a fashion similar to Subtopic 605-35. Paragraph 91 of the 2011 Draft directs the entity to “recognize an asset for [certain] costs.” As noted above, the construction contract is the profit center for the contractor. It is essential that the surety be able to assess the contractor’s profit on each project (both total estimated profit and profit earned to date). We request more guidance regarding how the 2011 Draft affects how costs and gross profit are recognized over the course of the contract.

Similarly, because the 2011 Draft suggests that the percentage of completion method can continue to be used in certain cases, but does not explicitly refer to the percentage of completion method, we suggest a mapping between the requirements of the now superseded Subtopic 605-35 and the 2011 Draft (Topic 605). In addition to assuring that the informational value of the percentage of completion method is retained, there are practical considerations as well. For example, under Internal Revenue Code § 460, revenue from most long-term construction contracts must be reported on the percentage of completion basis. In applying Topic 605, the entity needs to be certain that it is complying with this statutory requirement.

In sum, we are encouraged that certain elements of the percentage of completion method are retained. We seek greater certainty, however, that the 2011 Draft retains all features and aspects of percentage of completion accounting. We thank you for your consideration and would be happy to discuss our comments further.

Sincerely,

Robert J. Duke