## The Surety & Fidelity Association of America

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Via U.S. Mail and Electronic Mail

Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk CT 06856-5116

Attn: Technical Director - File Reference No. 1660-100

Re: SFAA's Comments on the "Preliminary Views on Revenue Recognition in Contracts with Customers" (File Reference No. 1660-100)

The Surety & Fidelity Association of America ("SFAA") is a national trade association of approximately 450 insurance companies that are licensed to write surety and fidelity bonds. SFAA member companies provide the vast majority of surety and fidelity bonds in the United States. We appreciate the opportunity to provide comment regarding the Financial Accounting Standards Board's "Preliminary Views on Revenue Recognition in Contracts with Customers" ("Discussion Paper").

A surety bond is a three party agreement by which the surety secures the obligation made by one party (the bond principal) to another party (the obligee). Unlike other forms of insurance, a surety does not expect a loss when writing a bond, and provides a bond only to those entities that appear capable of performing the obligation owed to the obligee. A critical part of the underwriting process is an assessment of the principal's financial position by analyzing the principal's financial statements. This analysis provides information regarding the principal's ability to maintain operations, perform the obligation, and, if necessary, reimburse the surety in the event the surety incurs a loss under the bond. Therefore, surety companies are significant users of financial statements. Sureties have a strong interest in being certain that the information provided by a financial statement is clear, consistent and fully disclosed.

Although sureties provide bonds to companies in a wide array of industries, and analyze financial statements from a variety of businesses, the comments contained in this letter focus specifically on financial reporting and revenue recognition by construction companies. A significant portion of surety bond premiums generated by the industry come from performance and payment bonds that must be posted by construction companies. A performance bond provides assurance that the project will be performed in accordance with the terms and conditions of the contract. Payment bonds secure the contractor's obligation to pay its subcontractor and suppliers. Of course, the primary source of a contractor's revenue is the revenue generated by its construction contracts. Sureties desire a revenue recognition method that accurately reflects and measures the contractor's business activity, and properly accounts for the unique characteristics of a construction contract.

As a general point, the proposed standard set forth in the Discussion Paper disregards many of the unique aspects of revenue recognition in construction, and would create unnecessary expense and complexity. At S11, the Discussion Paper states, "The Boards have not excluded any particular contracts with customers from the proposed model." We encourage FASB to consider excluding construction contracts from the proposed approach. To support our general position, we respond more specifically to two questions posed by the Discussion Paper.

## Question 2

Are there any types of contracts for which the Boards' proposed principle would not provide decision useful information? Please provide examples and explain why? What alternative principle do you think is more useful in those examples?

## Question 9

The Boards propose that an entity should recognize revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.

Revenue recognition for construction contracts requires specialized treatment. A single revenue recognition principle loses sight of the reasons for the different standards for different industries – to address the wide diversity in how revenues are generated. The American Institute of Certified Public Accountants, in its Statement of Position 81-1 ("SOP 81-1"), recognized the unique nature of construction contracts: the long term nature of the contract and the need to measure results in a short-term accounting period, the considerable and necessary use of estimates and the need to continually evaluate "the uncertainties inherent in the performance of contracts." A "one size fits all" approach is not ideal, particularly for construction contracts.

For example, because most construction contracts by their nature are long-term, the underlying accounting principle of matching — expenses follow revenues — may be violated if revenues are not matched with corresponding costs. In example 5, beginning at A32, the contractor would show no gross margin earned during the quarter ended June 30, even though it incurred \$300,000 in costs on a contract expected to earn a \$150,000 profit. It is logical to presume that a portion of

revenues should be recognized during the period that costs were incurred. Under the proposed approach, revenues are not matched with corresponding costs incurred.

In addition to the long term nature of construction contracts, a unique characteristic is the frequent changes to the contract and to the contract price. The proposed approach disregards this reality. Section 5.39 of the Discussion Paper questions the need to measure performance obligations at each financial statement date. The provision states, "Changes for other reasons (for example, changes in the price or quantity of goods and services yet to be transferred to the customer) are not significant in most contracts with customers." This statement is hardly applicable to construction contracts. Change orders, penalty provisions, savings incentive clauses, alternate adds and deducts are examples of some common contract provisions that could change the value of the contract throughout the term of the contract. Such changes require periodic remeasurement. With respect to construction contracts, remeasurement must take place beyond instances of when the contract is deemed onerous, as proposed by Sections 5.55 et seq.

Moreover, a revenue recognition approach based on the nature of the contract may lead to disparate treatment of economically similar contracts. Sections 4.46 and 4.47 give examples of a construction contract. Under the first scenario, the performance obligation is not satisfied until completion of the house, so revenue is not recognized until that time. Under the second scenario, because the materials are transferred to the customer as construction progresses and the customer "controls" the partially completed house through the construction process, revenue is recognized throughout the construction process. Thus, the contractor and accountant must conduct a fact specific analysis for each contract to determine if the customer "controls" the partially completed improvement to ultimately determine when revenue is recognized. The user is left analyzing contracts on the same financial statement that are treated differently and is deprived of the consistent treatment that he or she seeks. Further, as proposed, when a customer "controls" the asset can be subject to differing interpretations. Extensive guidance would be needed to provide for consistent treatment as among contracts of the same contractor and as among different contractors.

Lastly, in addition to the concerns regarding the capability of the proposed approach to measure properly the realities of construction contracting, the proposed approach would increase costs for sureties. Sureties typically have computer programs and software that assist the user in analyzing the contractor's financial statement. Such programs contemplate that the contractor uses the percentage of completion method of revenue recognition. If the proposed approach is implemented, sureties would be required to redesign their analysis programs. In addition, significant training expense to teach underwriters the new accounting methods would be incurred.

## Conclusion

SOP 81-1 properly addresses the complex and unique issues of construction accounting. It has been in place since 1981 and has been effective for establishing consistent treatment in financial reporting for construction contracts. The proposed approach in the Discussion Paper is a departure from this well-established standard and likely will cause detrimental effects: increased audit costs, less consistency, increased training costs for users and a decrease in the usefulness of

financial statements. We encourage FASB to retain the general principles of SOP 81-1 and exclude construction contracts from the generalized treatment proposed in the Discussion Paper.

We thank you for your consideration. We would be happy to discuss our concerns further with FASB.

Robert J. Duke