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The Chairman
International Accounting Standards Board
First Floor
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Via Email: commentletters@iasb.org

Dear Chairman

ITC 18 - Request for Comment on IASB Discussion Paper Preliminary Views on Revenue Recognition in Contracts with Customers ("DP")

Leighton Holdings Limited is the parent company of Australia's largest project development and contracting group. The Group includes Leighton Contractors, Thiess, John Holland, Leighton International, Leighton Properties and Leighton Asia. With around 37,000 employees, the Group's operations are spread all around the Asia-Pacific region on projects in Australia, New Zealand, Hong Kong, Indonesia, Malaysia, Singapore, the Philippines, Thailand, Vietnam, China, Mongolia, Laos, Cambodia, Taiwan, Sri Lanka, Macau, India, United Arab Emirates, Qatar and Brunei. Leighton Holdings Limited is listed on the Australian Stock Exchange and has its head office in Sydney.

We appreciate the opportunity to respond to the IASB's request for comments on the IASB Discussion Paper ("DP"): Preliminary Views on Revenue Recognition in Contracts with Customers.

Our focus on the DP has been from the point of view of long term construction contracts and we have provided a general overview on the potential impacts the proposal could have on the construction industry in Appendix 1. The IASB specific questions have been addressed in Appendix 2.

In summary, we believe that construction is a service rather than the delivery and sale of good and should be clearly defined as such in the new revenue recognition model. Classifying construction as the delivery and sale of a good could lead to issues regarding the timing of the transfer of control, which in turn could lead to less reliable and relevant information being prepared by contracting companies.



The unique nature of construction justifies specific guidance in areas such as variations to the contract and we look forward to future pronouncements addressing those areas currently addressed in IAS 11.

Please do not hesitate to contact me if you require any further information on our submission or would like to discuss any issue in respect of revenue recognition. We would welcome the opportunity to be involved in the further development of this standard and are willing to provide further submissions and presentations as required.

Yours faithfully LEIGHTON HOLDINGS LIMITED

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Attach Appendix 1: Overview of the Revenue Recognition Discussion Paper

in relation to long term construction contracts

Appendix 2: Responses to the specific questions in the Revenue Recognition Discussion Paper

APPENDIX 1

Overview of the Revenue Recognition Discussion Paper in relation to long term construction contracts

1. Background

Long term construction contracts are unique and merit specific guidance in the new revenue recognition model. The DP does not directly articulate whether construction involves the provision of a service or the delivery and sale of a good to a customer. The DP also does not address other accounting issues around construction contracts currently addressed in IAS 11.

We believe any proposed standard would be enhanced by specifically addressing issues particular to construction and defining construction as the provision of a service.

2. Nature of construction contracts

Construction contracts are different in nature to other commercial agreements and require specific accounting guidance. Characteristics of construction contracts include:

- Long term cover several reporting periods;
- Unique no two construction contracts are the same;
- Specified by the client the major structural elements of the design both before and during construction are specified by the client (this contrasts to the "manufacture of goods to a customer's specifications");
- Variable contracts are written to accommodate changes in scope, time and in transaction price;
- Service a construction service is being provided as all activities are done on behalf of the client; and
- Delivery the customer receives the right to the work in progress during construction and is unable to return to the contractor the works in progress (for example, a partially completed road).

The IASB has also acknowledged the unique nature of construction contracts as demonstrated by the current specific accounting standard IAS 11.

It is our view that defining construction as a service in future accounting pronouncements will address some of the unique aspects of construction contracts, including the need to progressively recognise revenue.

3. Construction as a service

The Boards note in 1.14 that distinguishing between goods and services is a problem in IFRS and a lack of clear distinction reduces the comparability of revenue across entities.

We do not believe the current proposal addresses this issue, particularly in relation to construction. We would seek to clarify this in relation to construction activity by defining construction activity as agreement for the rendering of services.

The construction industry is a service industry with construction activity driven by the customer. Construction activity is only undertaken when agreed to by the customer, as opposed to creation of inventory.

As a result, we believe that a clear definition of construction as a service in the proposed revenue recognition model would:

- Ensure the model reflects the nature of construction activity where the customer specifies the main elements of structural design.
- Help to address the issue raised in 1.14 that distinguishing between goods and services is a problem in IFRS.
- Allow the continuation of existing percentage of completion accounting for construction contracts avoiding the potential economic and financial impacts of a model where revenue would be recognised only at the end of a construction contract.
- Assist in addressing changes in contract terms and conditions not currently addressed in the proposals, but addressed in IAS 11.
- Avoid some of the practical difficulties and associated costs of implementing the proposals (discussed further below).

4. Potential impacts if construction is not defined as a service

Not defining construction contracts as a service carries the risk of delaying revenue recognition to completion of the contract as it could be deemed that control of the asset only transfers upon completion. This would significantly impact the construction industry.

4.1 Transfer of control

The question as to when control of the asset has transferred to the customer under a construction contract is not clear.

The proposals could result in the economic substance of transactions not being reflected due to the prevalence of legal form in the proposals relating to the transfer of control.

A legal concept of control could result in delaying the recognition of revenue on construction contracts until legal control has passed to the customer at completion; notwithstanding that the economic substance is that the customer receives the right to the work in progress during construction.

From a practical point of view, the customer is unable to return the works in progress or completed asset, for example a partially completed road. This reinforces the view that construction is not the delivery and sale of a good, rather, the provision of a service. This is also reflected in the accounting of the customer that recognises an asset under construction on the balance sheet, despite not having legal control. In contrast, there is no doubt when the customer has received a service.

4.2 Potential impacts of deferring revenue recognition

A revenue recognition model which defers recognition until completion of a construction contract would have the following potential impacts:

- Accounting rules could drive business practices as there would be a preference to bid for shorter rather than longer term contracts, impacting the viability / delivery of major infrastructure works.
- A need to hire and train staff to identify separate performance obligations and allocate stand-alone transaction prices in large and complex construction contracts.
- A need to develop new systems to record and track the satisfaction of separate performance obligations for financial reporting purposes that will overlay existing systems that need to remain focussed on measuring cost for monitoring management performance and remuneration.
- A major disconnect between financial and management reporting with substantial time and resources being used in reconciliation.
- A significant increase in additional reporting outside the primary financial statements to ensure users understand underlying performance.
- Significant tax accounting consequences of deferral of accounting income, compared to tax income paid on a progressive earnings basis.
- An inability to provide a return to shareholders due to dividends being required by law to be paid from profits. This could impact on contractors' ability to raise capital and debt due to the volatility of revenue reporting which could also be a significant barrier for new entrants to the construction industry.
- All additional costs would be passed on to customers.

5. Other accounting areas not currently addressed

We note that "changes in the contract's terms and conditions after inception" has not been addressed in the DP (Appendix C: Topics not covered in this Discussion Paper). Given the significance of such changes in construction contracts (i.e. cost escalation clauses, variations, claims, incentive payments and extension of time) further guidance on how the proposed model would deal with these items would need to be provided.

We believe our proposed refinement to the DP to define construction as a service would assist the model in addressing changes in contract terms and conditions.

We also highlight that there are other areas currently addressed in IAS 11 that are not considered in the proposals, including:

- combining contracts;
- changes in a contracts terms; and
- cost recognition guidance.

We believe the loss of guidance, particularly in relation to costs, would be detrimental.

6. Conclusion

In principle, we agree with the proposal to have a single revenue recognition model.

Construction contracts however, have a different nature to other commercial agreements and require specific accounting guidance in the new revenue recognition model, as reflected in IAS 11.

In our view, construction is a service as opposed to the delivery and sale of a good. Accounting for construction as a service addresses this unique nature and provides the most relevant and reliable method to users of financial information by progressive recognition of revenue.

We believe any proposed standard would be enhanced by defining construction as a service. Any exceptions to this definition should be clearly articulated and supported by examples. This would better reflect the economic substance of construction contracts and avoid the potentially significant undesirable economic and financial impacts.

APPENDIX 2

Responses to the specific questions in the Revenue Recognition Discussion Paper

Question 1: Do you agree with the Boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?

Yes. In principle we agree with the proposal to have a single revenue recognition principle.

We do not agree however, that there is an inconsistency in revenue recognition principles in IAS 11 and IAS 18 as stated in 1.15 of the DP.

An inconsistency exists only if long term construction is regarded as the sale and delivery of a good (as opposed to the provision of a service).

Construction of an asset under a customer's direction is a service progressively delivered and is best measured by the activities in bringing the asset to completion. The customer can specify the major structural and functional elements of the design before or during construction, therefore the activities performed for the customer should be the basis for assessing performance and recognising revenue, irrespective of legal control. The timing of revenue recognition should be progressive, as the services are provided.

We believe construction is a service and there is a clear distinction between the construction of an asset under a customer's direction and specification, compared to the production of an item of inventory which is available for sale to any customer, notwithstanding both assets may take an extended period to produce.

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?

Yes. We have concerns regarding the application of this model to long term construction contracts where the asset being constructed is at the direction of the customer.

If the model results in revenue being recognised only upon completion of a contract, we consider that this would not provide relevant and reliable information to users of the financial report and may have significant economic and practical impacts.

Deferring revenue on construction contracts until completion could result in a preference for contractors to perform shorter rather than longer term contracts. This may impact on competition in the market as some contractors would avoid bidding for the longer term contracts. This unintended behaviour could result in delays to or suspension of major infrastructure works.

In the current economic climate, governments around the world are aggressively pursuing the upgrading and implementation of infrastructure, such as water treatment plants, road and rail transport, and power plants. It would be unacceptable if the viability of such projects was jeopardised due a change in accounting.

Another possible impact is this proposal may constitute a significant barrier to new entrants into the construction industry. An inability for a start-up company to recognise revenue during construction phases will result in initial periods of loss making. Combined with an inability to declare dividends, this would limit potential investors to those with a longer investment horizon. Similarly, the potential for the start-up company to access debt may be impacted.

Users of the financial reports wish to see how the company has performed during the reporting period. Performance is represented by the company's profitability, or lack thereof. A model which recognises revenue only upon completion of a contract would disadvantage investors and analysts who would, effectively, be kept in the dark over a number of years. A consequence of this would be a significant increase in additional reporting outside the primary financial reports to ensure users understand underlying performance.

Reliance upon a legalistic concept of "transfer of control" may create inconsistencies across companies. We are concerned that slightly different legal clauses in contracts will create inconsistency of reporting. Contracts drafted in different legal jurisdictions may exacerbate the problem, when essentially the substance of the work being performed is the same.

Question 3: Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.

Yes, we agree with the Boards' definition of a contract and consider both written contracts and implicit contracts should be captured by the standard.

Question 4: Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.

Yes, but we have concerns as to what level the DP would require the separate identification of performance obligations in respect of long term construction contracts.

For example, a contractor could be appointed to construct a mixed use development comprising a separate hotel, office block and retail facility. The performance obligations could be interpreted to be one of:

- 1) Construction of all three buildings;
- 2) Construction of each separate building;
- 3) Construction of individual floors;

- Construction of the specific elements (i.e. façade, air conditioning or plumbing, fit out etc);
 or
- 5) Laying each individual brick.

We believe that appropriate separation of performance obligations would be items 1 and 2 above only.

Requiring separation of performance obligations to the more detailed levels as indicated in items 3 to 5 is of little relevance to users and will lead to:

- Arbitrary or artificial identification of performance obligations implicitly embedded within contracts for the sole purpose of meeting the requirements of an accounting standard.
- Inconsistent identification of performance obligations across similar contracts.
- Significant costs incurred to implement and maintain systems to track numerous performance obligations.
- Subjectivity in allocating the transaction price to each performance obligation.

It is not practical or relevant for performance obligations to be separately identified to a detailed level. We strongly agree with the comments raised in paragraph 3.22 outlining the practical difficulties and accordingly, suggest that the measure of the extent to which services have been continuously transferred is best measured by reference to the stage of completion.

Industry practice for determining the stage of completion is by reference to costs to date compared to costs at completion. This reflects our view that progressive revenue recognition linked to the activities and progress on the long term construction of the asset is the most relevant and meaningful driver of revenue recognition and reflects the economic substance of construction services.

Question 5: Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

Yes, however long term construction contracts should be regarded as the provision of a service which, in substance, results in the continuous transfer of the asset to the customer.

Refer also to commentary in Question 4,

Question 6: Do you think that an entity's obligations to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?

We comment to this question only to highlight the unique nature of construction contracts where it is impossible for the customer to return the good and obtain a refund.

This indicates clearly that the contractor is providing a service to the customer and not selling a good.

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Question 7: Do you think that sales incentives give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

No comment.

Question 8: Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised services? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

With regard to the "receipt of the promised service": yes.

With regard to "controls the promised good": further clarification is required with regard to construction contracts (should a construction contract be deemed to be the delivery and sale of a good rather that a provision of a service).

The definition of 'transfer of control' is crucial in this model as it is the trigger for the revenue recognition, however more clarification and guidance is required as to what constitutes 'transfer of control' of an asset as required in paragraphs 3.18 to 3.20 with reference to construction contracts.

The proposals could result in the economic substance of transactions not being reflected due to the prevalence of legal form in the proposals in relation to the transfer of control. A legal concept of control could result in delaying the recognition of revenue on construction contracts until legal control has passed to the customer at completion, notwithstanding that the economic substance is that the customer receives the right to the work in progress during construction and has received the service.

From a practical point of view the customer is unable to return to the contractor the works in progress, for example a partially completed road, which demonstrates that the contractor has provided the service and in substance, transferred the asset to the customer.

One should also consider the accounting by the customer. As the contract progresses the customer accrues a liability to pay for the services received in creation of an asset (being an "asset under construction"). This is an indicator that in substance, the asset is being transferred to the customer, albeit not legal control.

We also note that the DP model appears to be inconsistent with Concession Arrangements under IFRIC12 whereby the grantor of the concession records the asset on its balance sheet as the legal owner even though it does not control the asset for the period of the concession.

We believe that long term construction contracts should be defined as a service with exceptions (if required) to this definition clearly articulated and supported by examples.

Question 9: The Boards propose that an entity should recognise 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.

Further clarification is required with regard to long term construction contracts.

Should construction contracts be deemed to be the delivery and sale of a good, clarification on when control of an asset is transferred to a customer is required.

As commented in Question 8, we believe that construction results, in substance, in a continuous transfer of assets / control of assets to the customer. Inconsistencies between similar contracts will arise should the concept of continuous transfer not be adopted.

To illustrate, consider the following two examples for a contract to construct a building and our interpretation of the revenue recognition outcome under the DP:

| Entity | Contract terms | Interpretation of revenue recognition profile under the DP |
|--------|---|---|
| 1 | Progressive handover of each floor of the building as contemplated by Example 5 of the DP (i.e. milestone driven) | Revenue recognised on a proportionate basis as each floor is accepted by the customer. |
| 2 | The entire building is handed over at completion. | No revenue is recognised until the building is completed, certified and accepted by the customer. |

This example highlights how one asset can be delivered with two different contractual arrangements for exactly the same activities and services being provided by the contractor. Legally the contracts are different but in substance, the contractor is providing the same service and accordingly should be accounted for similarly.

The DP would result in the performance of the construction contract being represented in two entities' financial statements differently. In fact, the contracts could be represented two different ways within the one entity.

Consequently, our view is that for long term contracts the decision-usefulness of the performance obligation approach is jeopardised and the comparability of financial statements is also compromised.

We believe that in this example the most appropriate outcome is for both contracts to be accounted for progressively as this is most representative of performance.

As commented in Question 8, we believe that long term construction contracts should be defined as a service with exceptions (if required) to this definition clearly articulated and supported by examples.

Question 10: In the Boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.

a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?

Yes, we agree that performance obligations should be measured initially at the transaction price as this is the most practical basis of measurement.

b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?

Yes, we agree that a performance obligation should be deemed onerous if cost exceeds the carrying value of the performance obligation.

We disagree however, with the assertion in 5.43 that the total amount of revenue recognised is equal to the transaction price. Variations, claims, incentive payments and extensions of time are an integral part of all construction contracts and they are not included in the original transaction price.

Variations, claims and incentive payments are not addressed in the proposals despite being clearly accounted for in IAS 11. As a result, we believe IAS 11 better reflects construction contracts and provides more meaningful guidance for preparers of accounts. The ED should provide guidance on such matters.

Currently the DP does not provide guidance on the treatment of changes in contract margin other than when contracts become onerous. It is common for construction margins to move during the construction period. Currently, such changes are dealt with via a "true up" in the current reporting period. This "true up" provides a more reliable measure of earnings compared to the DP, which contemplates a cost overrun being accounted for prospectively.

We note that using a "cost trigger" for re-measurement as suggested in 5.82 is similar to the test in IAS 11; however this approach would force preparers of accounts to maintain a continued focus on cost to complete, despite revenue recognition changing to be focused on satisfying performance obligation.

c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.

We believe the proposed measurement approach does not provide decision-useful information for variations, claims, rise/fall, early completion bonuses and progressive changes in margin. Also refer response to Question 10(b).

d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.

Refer to Question 10 (b) response.

Question 11: The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges a customer to recover any costs of obtaining the contract (e.g. selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.

a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contracts should be included in the initial measurement of an entity's performance obligations? Why or why not?

We believe that different accounting is required depending on the nature of the pre contract award costs on long term construction contracts.

With regard to long term construction contracts significant costs are incurred prior to the award of a contract. It is important to distinguish between contract origination costs and costs which will subsequently serve to discharge the performance obligation to the customer. Examples of the latter costs include costs associated with preliminary design, environmental impact studies, securing suppliers, etc.

Contract origination costs such as the costs of establishing (for example) a consortium of partners to deliver the project and costs akin to "selling " costs should not be included in the initial measurement of an entity's performance obligation as they do not relate to the overall construction service being provided. The recovery of these types of costs should be a separate transaction. Refer to Question 11(b) response.

Pre contract award costs which serve to discharge the performance obligations to the customer, such as preliminary design costs, should be included in the initial measurement of the performance obligations.

b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.

Significant external contract origination costs (over and above ongoing selling costs) that are incurred as part of a competitive bidding process should be capitalised to the extent they are recoverable. This should be from the point where the award of the contract is virtually certain.

We also strongly believe that upon award of a contract, those previously expensed costs which serve to discharge the performance obligations to the customer should be reversed.

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For example, the costs associated with developing a design solution that conforms to the required specification, represent an integral part of the satisfaction of the performance obligation and therefore, should be capitalised when the bid is probable of succeeding. These costs are reflected in the overall transaction price.

Question 12: Do you agree that the transaction prices should be allocated to the performance obligations on the basis of entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?

Refer to Question 4 response.

Question 13: Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for the purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Refer to Question 4 response.