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Comment Letter No. 142

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Technical Director
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Discussion Paper: *Preliminary Views on Revenue Recognition in Contracts with Customers*

Dear Sir or Madam,

Thank you for the opportunity to comment on the FASB/IASB joint Discussion Paper on revenue recognition. I appreciate the boards' willingness to more fully understand the implications of such a significant pronouncement. The Lane Construction Corporation is a large, privately held construction company with annual revenue of approximately one billion dollars which includes work on more than 1,500 contracts annually. I believe the rules as currently outlined pose unique challenges to the construction industry which I will attempt to address herein.

In response to some of the questions outlined in the Discussion Paper, my responses are as follows:

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?*

   I agree with the theory of a single revenue recognition principle to ensure that similar transactions are accounted for similarly. However, I believe that a clear definition of the concept of control is needed, including a list of indicators of control, which will provide sufficient guidance for all industries. In many industries, including the construction industry, performance under the contract is a continuous process that may last a period of several years. In such circumstances, financial statement preparers need additional guidance on the indicators of continuous transfer of control. I recommend adding examples of possible indicators including:
   - Receipt of non-refundable payments
   - Customer's access to product being constructed
   - Customer's ability to specify the design either before or during construction
   - Customer's control of construction (including schedule and subcontractor selection)
   - Physical location and characteristics of product being constructed (i.e. is it permanently affixed to the customer's property)
   - Right of return

Such indicators should not be viewed as "bright line" tests but could assist preparers in determining when the activities of an entity further the earnings process. **In situations of continuous transfer of control, I believe an entity should recognize revenue based on its activities.**

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?*

   It is my understanding that the boards have identified certain contracts (financial instruments, insurance contracts, and leasing contracts) that are considered unique and warrant separate projects. **I believe that the construction industry is unique enough to be considered for an exception to the proposed standards.** As noted within this letter, the application of some of the boards' proposals as currently written would be impractical to comply with in an entity with thousands of contracts open at any time. However, with that said, the responses contained in the remainder of this letter assume that construction contracts are not excluded from of the final pronouncement.

4. *Do you think that 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.*

   No, I believe that the boards need to provide a clearer principle and additional illustrative guidance what constitutes an obligation. In the construction industry, each contract may require thousands of items of work to fulfill the contract, including labor, equipment, subcontractor costs and many different materials. Additionally, many of these items are being performed simultaneously and continuously. I do not believe the current definition of a performance obligation is clear enough to define what makes up the obligation in these circumstances.

   Additionally, entities frequently determine that it is necessary to incur certain indirect costs during the construction process that never transfer to the owner. One good example of such a cost for construction contractors is the rental of an office trailer on the job site. The contract will not specify that the contractor is required to rent a trailer but instead, the contractor chooses to do so in order to manage the job more efficiently. Such a cost does not seem to fall within the scope of the current definition of a performance obligation but is part of the contractor's activities in the earnings process. Similarly, the rental of a piece of equipment, such as a crane, on the job site is a more direct cost but again, not specifically required under the contract. I believe the proposed standards should treat these activities similarly and consider these activities as part of the entity's performance obligation.

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?*

I do believe that an entity should separate the performance obligations when it transfers the assets at different times. However, further guidance is needed on the measurement of the performance obligations. Many construction contracts can be categorized as either lump sum contracts or unit price contracts. In a lump sum contract, the contractor agrees to complete a given project (i.e. build a road) and is paid a fixed price for doing so. In this scenario, I believe that there is one performance obligation; to build a road. If the boards' definition of a performance obligation would lead and entity to conclude that each hour of work and each unit of material placed were separate performance obligations that require separate accounting, users of the financial statements would not be provided with decision-useful information, nor would it be practical to apply. Alternatively, under a unit price contract, a contractor is paid to build the same road but is paid based on the quantities put in place. For example, the contractor will be paid a certain price for each pay item which may include one price for each cubic yard of dirt moved, another price for each ton of asphalt placed, another price for each linear foot of guardrail installed, etc. Similar to the above contract, in this type of contract, it would not be practical to disaggregate the performance obligations and identify the number of units of each pay item that have been completed during a given period as each contract could include hundreds of pay items. Alternatively, when a contractor enters a lump sum contract, it would not provide the reader of the financial statements with decision-useful information if no revenue were recognized until such time as the single performance obligation (in the current example, to build a completed road) was fulfilled. Further, and seemingly contrary to the boards' intentions, it seems as though these two types of contracts (lump sum and unit price) could be accounted for very differently based on the guidance in the Discussion Paper. Contractors often have little influence on the contract language and under the current guidance two contracts can result in varying revenue recognition based on the contract language, even if the substance of the contract is very similar. It also would be very impractical for financial statement preparers to account for thousands of such contracts, which may all have slightly different terms, in a consistent, accurate and reliable manner. As such, I believe the performance obligation in each type of contract described above, should be the contract in its entirety.

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 service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.*

   In many revenue transactions, I agree that transfer of control is an adequate measure of when a performance obligation is satisfied. However, in cases of continuous transfer, this model seemingly focuses too heavily on legal control rather than effective control. In nearly all cases in the construction industry, the asset being constructed is done so on the customer's property, can be used by the customer (in at least a limited capacity) during construction, is custom built specifically for that customer, and cannot be returned to the contractor by the customer. I believe that each of these circumstances represent indicators of control passing to the customer continuously during construction. The Discussion Paper does not adequately outline how the obligation should be measured, and therefore, how to separate the obligations when there are many performance obligations which are being fulfilled continuously and simultaneously.

However, I believe that the current standards provide such guidance regarding segmenting the contract.

I agree with the boards' views that the consideration should be allocated on a relative fair value basis. However, I believe that the guidance should allow for an entity's cost to be an indicator of fair value. In using this method, the entity would realize revenue based on the relative cost of the items completed by the contractor, thus recognizing a consistent margin percentage as it satisfies each of its performance obligations. In the construction industry, cost estimates are generally reliable as they are made continuously as part of the bidding process.

I believe that the readers of financial statements are interested in how the activities of an entity which are performed in order to fulfill its performance obligations correlate to the earnings process. Without significant amendment to existing guidance on the definition of an asset, many of the costs incurred during the earnings process would not be offset by corresponding increases in assets or revenue. This would add additional and unnecessary volatility to the financial statements that would be detrimental to the usefulness of the financial statements. In the construction industry, contractors often incur significant indirect costs at the beginning and end of their work on contracts in order to mobilize and demobilize to and from the job site. These costs do not meet the definition of an asset under other existing guidance but are essential to the earning process. As such, I believe the entity should include such costs as part of the performance obligation, although not specifically stated in the contract, and realize revenue as these activities are performed. Similarly, contractors incur significant indirect costs that are not specifically required under the contract. I also believe that these costs should be considered performance obligations if deemed to be necessary costs to the earnings process by the contractor. As these costs are incurred, I believe the contractor would then be fulfilling part of its performance obligation and should therefore realize revenue for those efforts.

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.*

As discussed above, I believe the proposal needs to expand the definition of a performance obligation and needs more clarity regarding the satisfaction of performance obligations and the related measurement of those obligations. Users of the financial statements want to know how much profit or loss is expected for contracts and how much progress the contractor has made toward the completion of those contracts. The efforts of the contractor under the contract are not limited to the specific terms of the contract. As such, I believe the earnings process includes many activities that are not stated in the contract and therefore do not meet the boards' current definition of a performance obligation. The completion of only the individual performance obligations that may be outlined in the contract is not useful information for the readers of the financial statements as they are not privy to the terms of all the contracts an entity has entered into. The deferral of revenue until each obligation is met would add to the lack of comparability between periods and between companies without the specific detailed knowledge of the underlying contract terms.

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, in the asset and liability model proposed, the total performance obligation at the inception of the contract should equal the consideration to be provided. As a result, the revenue (which equals the total contract price) will be earned as the obligations are satisfied and the entity will recognize revenue based on its satisfaction of its obligations.

    (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, I believe that once it is known that a contract will result in a loss, the loss should be provided for at that time. This will require remeasurement of the obligation based on the estimated direct and incremental cost to satisfy this obligation. Any deferral of this loss until the obligations are satisfied would omit a liability to supply a good or service for a price at which the costs cannot be recovered. If such a liability were required to be disclosed rather than recorded, readers of the financial statements would adjust for these liabilities when assessing the entity's financial position. In subsequent periods as this loss was recognized, it is unlikely that the readers would then add back the loss when assessing the entity's performance, thereby counting this loss twice.

    As mentioned earlier, I believe the contract should be viewed in its entirety for purposes of identifying the performance obligation. Additionally, I believe the contract should be viewed in its entirety when deciding whether a performance obligation is onerous by comparing the total direct and incremental cost of fulfilling the contract to the total transaction price. I believe an entity should set out to recognize margin based on its original bid margin as it satisfies each performance obligation under the contract. In this scenario, margins would be consistent throughout the performance under the contract except when changes are made to the estimated transaction price or total contract costs. Any treatment other than this will cause contract margins to vary significantly over the life of the contract. Additionally, such treatment would be impractical to track and calculate in an entity with thousands of contracts, each containing hundreds of performance obligations.

12. *Do you agree that the transaction price should be allocated to the performance obligations on the basis of the 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?*

Yes, but in the construction industry, many of the items of work performed are not sold separately, rather they are performed in conjunction with other services. For example, a contractor never builds a concrete retaining wall without first placing the concrete forms. As such, there is no standalone selling price for many of the goods and services provided. However, I believe contractors can make reliable estimates of cost and that the relative cost of the performance obligations is a strong indicator of the relative fair value. Therefore, as costs are incurred in fulfilling performance obligations, profits should be earned on a consistent and rational basis throughout the life of the contract. Additionally, viewing the contract in total rather than at the individual performance obligation level reduces the ability of the financial statement preparer to manipulate earnings based on estimates.

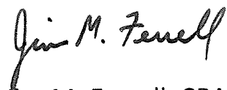
13. *Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?*

Yes, as stated earlier, contractors often perform services that are not sold separately. In such cases, I do believe that the contactor still satisfies its performance obligations as it performs these services and should therefore earn revenue as it does. In situations where an entity sells a good or service as part of its contract, I believe that the relative cost of such activities is a very strong indicator of the relative fair value of the good or service. Therefore, I believe the boards should allow for cost estimates to serve as a basis for estimating fair value.

In addition to the significant estimates a contractor must make relative to its cost of fulfilling its performance obligations, the contractor makes frequent estimates of the transaction price. In all contracts, but most notably in unit price contracts, a contractor must estimate the transaction price at the inception of the contract and on an ongoing basis throughout the term of the contract. As these estimates are made, I believe contractors should remeasure the transaction price, regardless of whether the revision increases or decreases the estimated transaction price. This will eliminate situations where large adjustments to the contract price are made at the completion of the contract which would cause significant adjustments to the profit or loss on the contract. Additionally, a contractor frequently faces situations where a portion of the transaction price is uncertain such as the case with unsigned change orders or contract claims. In these situations, revenue estimates should be constrained to amounts deemed probable after consideration of all potential adjustments for change orders, claims, modifications, etc. Other proposed methods which include uncertain revenue, such as a probability weighted estimates, add volatility and unreliable revenue recognition. These types of estimates, by their nature, always result in changes to revenue already recorded, including a high probability of negative revenue.

I would like to thank the boards again for allowing me to comment on these issues and for considering the opinions expressed in this letter.

Kind regards,



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