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Ladies and Gentlemen of the Board:

Thank you for this opportunity to present our thoughts on the Proposed Accounting Standards Update issued June 24, 2010 as respects Revenue Recognition (Topic 605). As way of introduction, Travelers is the largest writer of construction performance and payment surety bonds in the United States and Canada and given this market position is one of the largest users of audited financial statements prepared on behalf of the Engineering and Construction industry. Travelers’ representatives have participated extensively in discussions concerning these proposed changes having both met separately with the FASB Project Manager on this issue, Ken Bement, as well as participated as a panel member at the recent October 14 E & C roundtable event sponsored by PricewaterhouseCoopers. We understand that it has been thirty years since the accounting for revenue recognition Standard of Position 81-1 Accounting for Performance of Construction – Type and Certain Production-Type Contracts (SOP 81-1) (codified as Topic 605-35) has been updated and it is time to modernize this provision. We also understand that in this increasingly global economy, FASB’s standard must integrate International Accounting Standards 11, Construction Contracts (IAS 11), which governs how International Contractors have recognized revenue. This is an extremely challenging task and we’d like to offer our input as the various industry participants work to achieve a fair and balanced solution.

Historically, we believe that percentage of completion accounting (which has been used in the United State for the better part of thirty years) provides a very acceptable basis to allow Travelers and other sureties to compare E & C firms to other E & C firms to assist us in making individual credit decisions. We realize that individual E & C firms have not consistently employed the exact same methodology when calculating “percent to complete”,
but the overall methodology has been consistent enough, in our opinion, that we’ve been able to make thoughtful and sound credit decisions based on the financial information as presented. Whatever standard is ultimately adopted, we believe it is absolutely critical that this consistency in comparability of financial information be maintained. To that end, we’d appreciate your consideration of the following:

1. **Defining the Contract/Accounting for Performance Obligations – Percentage of Completion Calculation**

   - Contractors perform and sureties bond individual contracts or projects. The entire project is the risk to both parties. Although they are made up of some individual risk elements, but we strongly believe that as respects construction contract accounting, construction contracts should be viewed under the “continuous performance” concept and that contract segmenting of individual projects should only take place in rare instances where the prices for goods and services are truly independent. For example, we do not believe that design and construction should be accounted for separately on a single design-build construction project. We believe that today’s design-build contracts are fully integrated construction projects and that all revenue, cost, and profit recognition should take place on a “project” basis as that is how the prime contractor and the surety industry guarantees the risk. Our position also applies to when more than one category of work (i.e. bridge work and road work) are performed under a single contract by a prime contractor. We see this as a single risk and all revenue, costs, and profits should be accounted for in that manner as respects the prime contractor, which is responsible for all aspects of the project. Any change to that concept would not be viewed favorably by Travelers.

   - One of the major concepts discussed in the proposed model concerns the point at which control of the project is transferred to the Owner. As stated above, Travelers believes almost all construction contracts are for continuous performance. Travelers also believes that control of a project almost always transfers upon achievement of the project substantial completion date and/or certificate of occupancy. Most construction projects are subject to a specific completion date and this date triggers clear contractual direction as to when the Owner assumes control of the project. From a surety perspective, contract completion is a very significant date as it triggers a transition of our performance obligations to warranty exposure as guaranteed by the contract and bond as well as establishes the legal time frames under which law suits can be brought against the bond. We strongly recommend FASB take this date in to account when determining the occurrence of change of control of the project.

   - As respects Contract Modifications (change orders) to existing contracts, again it is our strong preference and belief that these be combined with the initial project accounting rather than any movement to try to account for these as separate obligations. We also believe that any guidance should make it clear that such Contract Modifications should be recognized in the revenue and percentage of
completion calculation only when it is highly probable (our preference is actually signed) that the change order will be approved by the customer.

- The one area in the existing methodology where we believe there is the greatest potential for improvement relates to requiring more consistent methodology in determining percentage of completion. Assuming most contracts are considered as “continuous performance”, we are comfortable that percentage of completion will continue as the best methodology for calculating revenue under the new provisions. However, under the existing rules, we see a wide variety of methodologies used to determine percent complete. Some firms will not recognize any profit until a certain percentage of work is completed. Others recognize profit right away. Some compare all total estimated costs to all costs incurred to date. Others may defer materials not incorporated in the job site or use expected total labor units to labor units incurred to date in determining percentage of completion. As a surety, we are not necessarily advocating one methodology over the next, but we would like to see some more uniform standards to govern the calculation of percentage of completion for all E & C firms. We also believe the calculation should be based on a comparison of some aspect of total expected costs to how much of that cost has been incurred to date. We do not believe the billing cycle should be a factor in determining the percentage of completion. Rather we believe revenue recognition should be linked to the agreed upon percentage of completion calculation. For example, if the agreed upon percentage of completion is 40%, then 40% of all revenue and profit should be recognized at that point in time, and the billings cycle, which may differ from project performance, would be accounted for in the “billings in excess of costs and estimated earnings” or “costs in excess of billings and estimated earnings” portions of the balance sheet as it is done today.

2. **Determining the Transaction Price**

- The proposed model recommends the use of a probability weighted approach to determine the amount of award/incentive payments and this mechanism may extend to change orders as well. We think this is an extremely poor idea as it does not accurately represent the amount of revenue that will ultimately be recognized. Consistent with conservative accounting practices, it is our recommendation that any incentive payments be recognized only when the milestone is achieved or the likelihood of achievement is extremely high. Any attempt to recognize a potential bonus earlier distorts the financial view from the perspective of a creditor.

- We believe the same approach should be used when considering potential contract claims as well. The recognition of any claim should be extremely conservative and only should be added to revenue when the settlement value is agreed to by all parties. We believe conservative accounting practices should discourage early recognition of claims and that the goal should be to avoid restatements and write-offs when the claims settle for less than what was deemed probable. We also believe that claims are independent obligations based on
independent facts and success on prior claims are not necessarily indicative of the expected outcome of future claims. The specific facts of the claim and the legal system in which they will be litigated are much more important factors and therefore we believe that the probability weighting of claims makes little sense.

- We are not opposed to the discounting of contract revenue to reflect the time value of money for long term A/R.

3. **Warranties**

- We oppose the proposed model, which advocates deferring a portion of revenue to account for quality assurance warranties and insurance warranties. We agree that E & C Firms’ have both warranty exposures on its projects. However, delaying revenue recognition until the warranty period expires is a very poor method to address this potential exposure. As stated previously, almost all construction projects and contracts have specified completion dates that typically triggers the start of the various warranty obligations. Thus it makes little sense to keep all of these contracts “open” once the completion time is reached. We believe the schedule of open jobs will become unwieldy and confuse backlog calculations, etc. We believe that potential warranties are better accounted for through the use of accruals on the “cost” side of the ledger rather than delaying revenue recognition. We believe that a reasonably accurate actuarial determination can be made for these likely unknown costs that would be adjusted each financial period based on work completed, historical performance, and other factors. Known warranties losses can be dealt directly with specific costs when incurred. Again, warranty loss does not generate revenue. It increases costs which lowers profit. The revenue is static.

4. **Retrospective Application**

- Our understanding is that E & C firms may have to go back five years and restate all their financial information when this standard is adopted. We do not think the benefit of this exercise in any way offsets the cost, even if it could be done. This retrospective adjustment will not impact the margin on any closed project during that period; it only may adjust when the margin or cost was recognized. The ultimate result does not change. Likewise, it will not affect cash balances, A/R totals, etc. Therefore, it will provide little to no benefit to our industry other than distract E & C firms management from more critical tasks in one of the most challenging economic times any one can remember. If this change is included in the final version, Travelers will not retroactively adjust our historical database of information as the enormous cost of the task far outweighs any benefits we might gain. Therefore, it is our recommendation that any retrospective application be implemented on a going forward basis with minimal disruption to the contractor.
In summary, Travelers is committed to working with FASB, the accounting industry, and the E & C industry to arrive at a workable revenue recognition solution that will ensure our ability to effectively compare E & C firm financial statements to each other. In order to achieve that, we maintain that almost all construction contracts are contracts of continuous performance and that the accounting should be based on the entire project and not individual segments. We also believe that percentage of completion methodology based on some level of comparing current expected total cost to date to cost incurred to date is the best way for the E & C industry to calculate earned revenue and profit. We are also interested in seeing greater consistency within the E & C industry in determining how percentage of completion can be calculated. We thank you again for the opportunity to share our views and we plan to continue to participate in future discussions as the issue moves forward.

Sincerely,

Stan Halliday