

# **Austin Industries**

100% Employee Owned

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Technical Director
File Reference No. 1820-100
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

#### Dear Director:

Austin Industries, Inc. appreciates the opportunity to respond to the Financial Accounting Standards Board Exposure Draft Revenue Recognition (Topic 605): Revenue from Contracts with Customers (the "Exposure Draft").

Austin Industries, Inc. is a Dallas, Texas based contractor providing construction services to the highway, commercial and industrial markets. We also provide maintenance services to the petrochemical segment of the industrial market. We are wholly owned by an Employee Stock Ownership Trust and are therefore considered privately held. Indications of size are annual revenues of between \$1.5 and \$2 billion and employment of between 5,000 and 6,000 employee/owners.

In general, we consider the Exposure Draft to be well reasoned and a good framework for revenue recognition across all industries. We have some concerns relative to its application to the construction industry and would appreciate additional clarification in various areas, all of which are indicated in the attached Responses to Questions for Respondents.

If we can clarify our comments or otherwise assist the Board, please feel free to contact Dana Bartholomew by mail at the address above, by email at danabart@austin-ind.com or by telephone at (214 443-5500).

Sincerely,

JT Fisher

CFO and VP, Finance

JTF/hlm

#### Austin Industries, Inc.

### **Recognition of Revenue**

Question 1 – Do you agree with the principle of price interdependence for use in determining whether to combine and segment contracts and contract modifications? If not, what principle would you recommend and why?

We concur that price interdependence is an appropriate principle for determining whether to combine or segment contracts.

However, we believe factors in addition to price interdependence should be considered when determining whether contract modifications should be combined or separated. Factors indicating that a modification should be combined with the original contract include the factors indicating price interdependence in paragraph 13 and the following indicators:

- 1. The modification is priced in accordance with provisions and/or unit pricing negotiated in the initial contract. This would be evidence that the commercial terms of the contracts were entered into at or near the same time.
- 2. The physical scope of the modification is so integral to the original scope as to be difficult to differentiate.
- If commercial terms were not negotiated at or near the same time as the original contract, the margin on the modification is not significantly different than on the original contract.

Question 2 – Do you agree with the principle in paragraph 23 for determining when a good or service is distinct for purposes of identifying separate performance obligations? If not, what principle would you specify and why?

We agree, based on certain assumptions from analyzing the implementation guidance.

When applying the guidance to the construction industry, we believe that a contract, in total, will equal a performance obligation in most cases. The basis of this interpretation is that construction involves a continuous flow of control to the customer and that typical contractual warranties are quality assurance warranties.

We request additional clarification relative to design-build projects. Where a contractor provides design services separately at a margin different than construction services, we believe the design services are a separate performance obligation with transaction price allocated based on relative market prices. However, other situations occur:

 A contractor does not normally provide design services separately, but performs design services with its own personnel on design build projects. We believe that since the market provides such services separately, design would still be a separate performance obligation with transaction price allocated on market pricing.

### Austin Industries, Inc.

- 2. A contractor does not provide design services directly, but where required by a contract, joint ventures with a design services firm. From the perspective of the joint venture, design would be a separate performance obligation with a separate margin because it is offered to the market separately and performed separately by one of the joint venture partners.
- 3. A contractor does not provide design services directly, but where required by a contract, subcontracts design services from a design firm. We believe that where design services are subcontracted, the design subcontractor is no different than any other subcontractor. Usually, the contractor would price for an overall margin for the contract, including all subcontractors. Subcontracted design services would be considered a component of the overall performance obligation. Our recommendation in this situation is based on:
  - a. The contractor does not provide design services separately.
  - b. The contractor and the market usually price subcontracted services based on an overall markup on cost.
  - c. Even though the market prices design services differently than construction services, the pricing differential is inherent in the pricing from the design professional to the contractor. The pricing differential is not reflected as different margins on design versus construction services by the contractor.

We also request additional implementation guidance on whether separate buildings on a common site are separate performance obligations. Additionally, would similar buildings on multiple physical sites be considered separate performance obligations?

Question 3 – Is guidance in paragraphs 25 – 31 sufficient for determining when control of a promised good or service has been transferred to a customer? If not, why? What additional guidance would you propose and why?

We consider the guidance in these paragraphs to be adequate as they relate to the construction industry. We cannot comment on adequacy for other industries.

#### Measurement of Revenue

Question 4 – Do you agree that an entity should recognize revenue on the basis of an estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach would you suggest for recognizing revenue when the transaction price is variable and why?

In the construction industry, the base transaction price is often clearly established and therefore able to be estimated, but the contractor has the opportunity to earn additional compensation in terms of performance bonuses and to erode margins with performance penalties.

We disagree with using probability analysis to estimate transaction price for variable compensation components of construction contracts. Such probability analysis is subject to significant subjective evaluation. One can easily envision two construction companies in exactly the same position relative to a project, but with different financial results based solely on

### Austin Industries, Inc.

differences in management's assessment of probabilities for purposes of estimating transaction price.

We suggest specific criteria for including performance bonuses/penalties in the transaction price. Criteria for performance bonuses should be more restrictive than for including performance penalties. Both criteria should be very conservative. We suggest the following:

- Performance bonuses and any other contingent compensation should not be added to transaction price until the contractor has a contractual right to the additional compensation. This is conceptually similar to recognizing revenue when a performance obligation has been met. Collectability concerns could reduce the amount of bonus added to transaction price.
- 2. Performance penalties should reduce earned revenue as soon as it is likely the penalties will be incurred. For example, if the performance penalty is for late completion of the project, potential penalties should be recorded as soon as the construction schedule indicates schedule slippage. This is conceptually similar to excluding cost of inefficiencies from calculation of percent complete since they effectively reduce earned revenue as they are incurred.
- 3. In the absence of the above situations, transaction price should be the transaction price before considering performance bonus or penalty.

Question 5 – Do you agree that the customer's credit risk should affect how much revenue an entity recognizes when it satisfies a performance obligation rather than whether the entity recognizes revenue? If not, why?

From the standpoint of accounting professionals within the construction industry, this proposal is ill advised and we disagree.

Our position is based on interpretation that revenue is recorded at a reduced rate reflecting credit risk. If we collect the full transaction price, the difference between the reduced revenue recognition rate and the amount actually collected is never recorded in revenue. If that is not the intention of the Board, more implementation guidance is needed for clarification.

There are several factors involved in our position:

- The construction industry generally improves real estate. Contractors are granted lien rights in domestic United States jurisdictions for work for which it has an unconditional right to compensation and has billed for that work. This provides a security interest in the property being improved and minimizes collectability problems.
- Credit evaluation occurs in the proposal process. To the extent a credit risk is perceived, it is included in the pricing decision along with other issues like operational complexity and competitor analysis. Price inherently includes credit risk.
- 3. Recording revenue at an amount less than the transaction price would be confusing, at least, and misleading to financial statement users.

### Austin Industries, Inc.

4. Management and management's accountants would record accounts receivable in an amount less than the amount to which it has an unconditional right to compensation. That amount and the amount to which the company has an unconditional right to compensation would both have to be tracked and reported. Substantial increased cost and confusion would be involved for an immaterial item in the construction industry.

Question 6 – Do you agree that an entity should adjust the amount of promised consideration to reflect the time value of money if the contract includes a material financing component (whether explicit or implicit)? If not, why?

We agree. However, we believe additional implementation guidance would help clarify this issue. Construction contract provisions commonly include mobilization and similar cash flow contract provisions designed to fund expected front-end cash flows of the contractor. Mobilization funding may be ten to fifteen percent of the contract price. When determining whether such advance funding is a material financing component, we believe it is appropriate to consider the amount and timing of related cash outflows as well.

Question 7 – Should the transaction price be allocated to all separate performance obligations in proportion to the standalone selling price (estimated if necessary) of the good or service underlying each of those performance obligations? If not, when and why would that approach not be appropriate and how should the transaction price be allocated in such cases?

We agree. In the construction industry, projects are usually unique and an estimate of costs and a desired margin on costs are usually the basis of the contractor's bid price. We believe allocation of the transaction price on the basis of the bid estimate is consistent with paragraph 52(a).

While agreeing on the basis for allocating the original transaction price among performance obligations, we disagree with allocating changes in transaction price among all performance obligations as required by paragraph 53. It states that "an entity shall allocate any changes in the transaction price to all performance obligations on the same basis as at contract inception".

Typically, contract transaction price changes are related to an identified change in scope of the work to be performed. The changes are usually based on cost estimates, similar to the original bid estimate. The scope of the contract change and the related cost estimate for the change in transaction price are typically clearly identifiable to one or more performance obligations.

We believe that one should allocate the transaction price change to the effected performance obligations based on costs and margin estimated for each performance obligation identified in the change. This would be on the same basis as the original contract allocation of transaction price per paragraphs 50-52, that is the estimated cost and margin on each performance obligation. In other words, where one can clearly identify the performance obligations to which the change applies, the change should be allocated to those performance obligations and not to all performance obligations.

#### Austin Industries, Inc.

This clarification is most significant where an output measure of continuous transfer is used as the basis of recognizing revenue and where the output measure must correlate to the transaction price.

#### **Contract Costs**

Question 8 – Do you think that the proposed guidance on accounting for the costs of fulfilling a contract is operational and sufficient? If not, why?

We would like additional guidance in specific areas to provide more clarity for the construction industry:

- 1. We understand costs that "generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is, the costs related to future performance)" and "are expected to be recovered" are considered assets. A component of such assets is materials purchased for the project, but not yet installed, typically called stored materials.
  - a. Since revenue is recognized based on satisfying performance obligations, one must assume materials stored for satisfying future performance obligations would be excluded from determining percent complete of the performance obligations.
  - b. Many contracts have provisions for billing the customer for stored materials. When stored materials are billed, the entity would have an account receivable and an offsetting contract liability. For presentation purposes, could the stored materials asset be offset by the contract liability associated with billing stored materials?
- We concur that costs to be expensed pursuant to paragraph 59 should include the costs
  of obtaining a contract, the costs related to past performance to satisfy a performance
  obligation, and the "cost of abnormal amounts of wasted materials, labor, or other
  resources used to fulfill the contract".

Guidance on how to determine abnormal amounts of wasted resources would be helpful. In our opinion, such costs would be those in excess of the estimated cost of completing the performance obligation as determined when preparing the bid proposal, as adjusted by any change orders combined with the base contract.

Question 9 – Is the definition of costs that relate directly to a contract in paragraph 58 appropriate? If not, what costs would you include or exclude and why?

We agree that the definition of costs that relate directly to a contract is appropriate and sufficiently broad.

We understand that pre-award expenses incurred in furtherance of a future contract performance obligation are considered a contract cost and are recorded as a contract asset until such time as the performance obligation is completed, or revenue has been recognized based

### Austin Industries, Inc.

on continuous transfer of control. We request implementation guidance clearly addressing this issue.

#### **Disclosure**

Question 10 – Do you think the proposed disclosure requirements help users of financial statements understand the amount, timing and uncertainty of revenue and cash flows arising from contracts with customers? If not, why?

We generally agree with the disclosure requirements except as indicated in Questions 11 and 18.

Question 11 – Do you agree that an entity should disclose the amount of its remaining performance obligations and the expected timing of their satisfaction for contracts with an original duration expected to exceed one year? If not, what, if any, information do you think an entity should disclose about its remaining performance obligations?

We do not agree with disclosing the amount and timing of remaining performance obligations for several reasons. For purposes of this discussion, we will refer to remaining performance obligations as backlog.

- 1. We are a private entity, so aside from management and our board, the primary users of our financial statements are a) customers for prequalification and proposal evaluation, b) banks and surety companies for bank and surety credit, and c) insurance companies underwriting commercial risks. Where required by agreement or where needed to establish a relationship with financial institutions, we provide backlog information on a supplementary, unaudited basis. That information is typically significantly more detailed than apparently contemplated by the Exposure Draft. Requiring backlog information in the financial statements would therefore be redundant to information provided to our key stakeholders, and would not improve information for financial statement users. This response should be considered to pertain to private companies; we do not care to comment upon this topic as it would pertain to public company reporting requirements.
- 2. From the implementation guidance, we understand backlog information is to be aggregated for presentation purposes. If this is not the case, we would also disagree with providing backlog information for each contract.
- 3. Please note that we are already required to disclose concentrations of risk information that adequately addresses similar concerns of risk and uncertainty.
- 4. Construction work is largely awarded based on competitive bidding. We believe there is a perception, at least, of an inverse correlation between level of backlog and appetite for risk in our industry. Understanding one's competitors' backlog status may influence bidding and pricing strategy. Disclosures should not affect competitive balance, and any new policies should be sensitive to customer and company confidentiality concerns.

In response to the second half of this question, an entity should disclose and reconcile onerous performance obligations and disclose concentration of risk in future performance obligations.

### Austin Industries, Inc.

Question 12 – Do you agree that an entity should disaggregate revenue into the categories that best depict how the amount, timing and uncertainty of revenue and cash flows are affected by economic factors? If not, why?

We generally agree with this principle and would expect to disaggregate revenue into quaranteed price versus cost reimbursable contracts.

#### Effective date and transition

Question 13 – Do you agree that an entity should apply the proposed guidance retrospectively? If not, why? Is there an alternative transition method that would preserve trend information about revenue but at a lower cost?

We do not agree with retrospective application of the revenue recognition standard. Revenue recognition involves multiple management judgments in terms of what is a contract, what are the performance obligations, transaction price, probability of collecting transaction price changes, evaluation of credit risks and calculation financing involved. All of these judgments would be made in hind sight on both completed and uncompleted contracts. It would be highly unlikely that the results calculated today in hind sight would be the same as what would be calculated without the benefit of hind sight.

Additionally, the requirement is extremely burdensome. Implementation costs would be very high and would outweigh any benefit to financial statement users.

Alternatively, prospective implementation on contracts entered into after the effective date of the standard would be more cost effective and not subjected to retrospectively focused management judgments. Transition would be limited to the duration of the company's longest open contract.

See question 18 on effective date.

### Implementation guidance

Question 14 – Do you think that the implementation guidance is sufficient to make the proposals operational? If not, what additional guidance do you suggest?

Specific requests for additional guidance have been noted in the detailed questions.

In addition, we would like further implementation guidance on contract modifications. Paragraph 17 defines a contract modification while paragraph 18 defines when contract modifications are subject to revenue recognition requirements. Paragraph 18 refers to criteria in paragraph 10, one of which is that both parties must have approved the change.

In the construction industry, contracts anticipate contract modifications and provide processes that allow the project to proceed while protecting the rights of both parties. Customers commonly order contractors to proceed with work considered a contract modification by the

### Austin Industries, Inc.

contractor, prior to agreeing on price and schedule impact. Contracts typically allow this in exchange for the customer's commitment to negotiate a price for the modification, and pay a minimum of actual cost of the modification. We believe implementation guidance would be helpful in determining the impact on revenue recognition of such pending contract modifications. Where contracts provide for reimbursement of costs on such proceeding contract modifications, we believe the contractor should include in revenue the amount to which the contractor has a contractual right until such time as pricing of the modification is agreed to between the parties. Terms of the original contract would be the basis for determining that the parties have an agreement covering the contract modification and establishing minimum compensation.

Question 15 – Do you agree with the proposed distinction between the types of product warranties and with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

We concur with the distinction between a quality assurance warranty and an insurance warranty. We understand a quality assurance warranty is not a separate performance obligation, while an insurance warranty is a separate performance obligation. Assuming a continuous transfer of goods and services, a quality assurance warranty would result in a reduction of percent complete of the overall performance obligation in which it is included and therefore a reduction in earned revenue. Upon extinguishment of the warranty period, the transfer of a product free of defects has been completed and the remaining revenue would be recognized. We request implementation guidance on the timing of recognizing revenue related to quality assurance warranties. Assuming the performance obligation qualifies as a continuous transfer of goods and services, we assume that one would recognize revenue related to the warranty proportionally over the duration of the warranty period.

We also understand that costs of correcting defective work would be expensed to the performance obligation as incurred. We also understand there would not be a separate warranty liability on the balance sheet, but the unrecognized revenue would be a component of the contract liability.

In many, if not most cases, the contractor is the beneficiary of quality assurance warranties from subcontractors and manufacturers, and those warranties usually mirror the warranty obligations from the general contractor to the customer. Insurance warranties may also flow from subcontractors and manufacturers to the general contractor and from the general contractor to the customer.

We would appreciate guidance on what the contractor should record as its obligation in these scenarios. Should the contractor record its warranty obligation on self performed work, its obligation to manage warranty obligations of subcontractors and manufacturers, and any contingent obligation to perform warranty work of subcontractors and manufacturers should they fail to respond to customer demands? Alternatively, should an estimate of the contractor's gross warranty obligation to the customer be recorded as a reduction in revenue while the estimated sales value of the subcontractor's and manufacturers' warranty obligations to the

#### Austin Industries, Inc.

contractor are recorded as a reduction of contract cost? (The first alternative is recording a net warranty obligation while the second alternative would record a gross obligation.)

Question 16 – Where a license is not considered to be a sale of intellectual property, do you agree that the pattern of revenue recognition should depend on whether the license is exclusive? Do you agree with the patterns of revenue recognition proposed? Why or why not?

No comment.

### Consequential amendments

Question 17 – Do you agree that an entity should apply the recognition and measurement principles of the proposed revenue model to accounting for the gain or loss on the sale of some nonfinancial assets (for example, intangible assets and property, plant and equipment)? If not, why?

No comment.

### **Nonpublic entities**

Question 18 – Should any of the proposed guidance be different for nonpublic entities (private companies and not-for-profit organizations? If so, which requirement(s) and why?

We suggest reducing disclosure requirements for nonpublic entities as follows:

- 1. Eliminate disclosure of the amount and timing of future performance obligations for the reasons outlined in Question 11.
- 2. Eliminate the reconciliation of contract asset and contract liability as providing marginally useful information.

Additionally, we request public companies implement first with a minimum two year delay before nonpublic companies implement the new standard. Public companies have substantially more resources for implementing such a change than nonpublic concerns. The standard should also allow for early implementation where in the judgment of management, transition would be simplified or would result in more meaningful information to the users of financial statements.