



Steven D. Ness, President

April 3, 2012

Forwarded via mail and email

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Sir or Madam:

Re: Revenue Recognition from Contracts with Customers – Revision of June 2010 Exposure Draft

Introduction / Overview

At the outset, the Surety Association of Canada would like to convey its appreciation to the boards for this renewed opportunity to provide input into your efforts to develop an international standard for revenue recognition on long term contracts. To recap, our association is the national trade advocacy body that represents issuers of surety bonds; credit instruments which guarantee the performance of construction contractors in meeting their contractual obligations to their customers.

The boards have no doubt heard from other surety firms and trade organizations that the surety underwriting process is largely an assessment of a contractor client's credit worthiness. A very significant part of this evaluation is an in-depth analysis of the client's financial statements. Given this reliance on comprehensive and reliable financial information, it's an understatement to say that surety firms have a strongly vested interest in ensuring that appropriate standards for revenue recognition are applied in the preparation of these statements.

Before launching into our commentary, permit us to extend our compliments to the boards for the thoroughness and diligence that obviously went into the revisions of the original June 2010 draft. We see the new version as a vast improvement over its predecessor and are pleased to note that the comments we provided in our submission of October 19, 2010 were heeded and that many of our suggestions were incorporated into the current draft. A copy of our 2010 commentary letter is attached for reference.

In the discussion that follows we will provide you with the benefit of our thoughts on what we perceive to be the most pertinent issues affecting our industry. This will be done either by answering the questions put forth in the document itself or by ancillary observations on issues that weren't covered by the questions. For the most part, the suggestions advanced here would involve minor adjustments or clarifications.

Responses to Questions

Question 1: Paragraphs 35 and 36 specify when an entity transfers control of a good or service over time and, hence, when an entity satisfies a performance obligation and recognizes revenue over time. Do you agree with that proposal? If not, what alternative do you recommend for determining when a good or service is transferred over time and why?

Response:

One of our key concerns with the June 2010 Exposure Draft was the issue of "Transfer of Control" and its implications for a contractor's ability to recognize revenue on a percentage of completion basis. Paragraphs 35 and 36 provide the required clarification surrounding this concept by introducing the concept of satisfying the performance obligation "over time" (as opposed to "at a point in time"). Paragraph 35 sets out the criteria used to determine when an obligation is satisfied over time. Note that these criteria would seem to capture virtually every type of construction transaction and would thus permit revenue to be recognized as the work progresses.

Our only point of concern surrounds the use of the term "customer", particularly in Paragraph 35 where the concept of "over time" is essentially defined. We're concerned that this term may be too restrictive and create ambiguity when non-traditional methods of construction procurement and delivery are employed.

For example, in P3 (Public Private Partnership) contracts the work is often designed, financed, built and even operated by a private sector consortium which is composed of entities representing the various components (e.g. a design firm, a contractor, a commercial lender, etc). Typically, the consortium will incorporate a "special purpose vehicle" which for all intents and purposes acts like the project "owner"; i.e. contracting with the various parties, etc. In this case, the "customer" of the contractor would be this special purpose company with which it enters into the contract. However, true beneficiary of the contractor's efforts as set out in paragraph 35 would be the owner or end-user; typically a government body or property owner.

We're not sure how far reaching this issue is; nor are we sure about the implications that any changes may have for other sectors but we suggest that the term customer be broadened to capture these not un-typical scenarios; for example, Paragraph 35 (b) (i) could now read:

i. The <u>customer, end-user, or beneficiary</u> simultaneously receives and consumes the benefits of the entity's performance as the entity performs.

Question 2: Paragraphs 68 and 69 state that an entity would apply Topic 310 (or IFRS 9, if applicable) to account for amounts of promised consideration that the entity assesses to be uncollectible because of a customer's credit risk. The corresponding amounts in profit or loss would be presented as a separate line item adjacent to the revenue line item. Do you agree with those proposals? If not, what alternative do you recommend to account for the effects of a customer's credit risk and why?

Response:

We concur with this approach and believe that it adequately addresses the concern about accounting for bad debt expenses as expressed in our letter of October 19, 2010.

Question 4: For a performance obligation that an entity satisfies over time and expects at contract inception to satisfy over a period of time greater than one year, paragraph 86 states that the entity should recognize a liability and a corresponding expense if the performance obligation is onerous. Do you agree with the proposed scope of the onerous test? If not, what alternative scope do you recommend and why?

Response:

We have no issue with this proposal which we see as being consistent with current practice; i.e. requiring the entire anticipated loss to be recognized as soon as it is identified.

Question 5: The Boards propose to amend Topic 270 and IAS 34 to specify the disclosures about revenue and contracts with customers that an entity should include in its interim financial statements. The disclosures that would be required (if material) are:

- 1) The disaggregation of revenue (paragraphs 114–116)
- 2) A tabular reconciliation of the movements in the aggregate balance of contract assets and contract liabilities for the current reporting period (paragraph 117)
- 3) An analysis of the entity's remaining performance obligations (paragraphs 119–121)
- 4) Information on onerous performance obligations and a tabular reconciliation of the movements in the corresponding onerous liability for the current reporting period (paragraphs 122 and 123)
- 5) A tabular reconciliation of the movements of the assets recognized from the costs to obtain or fulfill a contract with a customer (paragraph 128).

Do you agree that an entity should be required to provide each of those disclosures in its interim financial statements? In your response, please comment on whether those proposed disclosures achieve an appropriate balance between the benefits to users of having that information and the costs to entities to prepare and audit that information. If you think that the proposed disclosures do not appropriately balance those benefits and costs, please identify the disclosures that an entity should be required to include in its interim financial statements.

Response:

Disclosure is a critical issue for surety firms who expend vast amounts of time and energy in an effort to understand the details surrounding revenue recognition; the methodology used, the judgments applied and calculations made.

At a recent consultation with representatives of the International Accounting Standards Board, we were asked to provide specifics regarding the form of disclosure sought by surety firms when evaluating a construction contractor's recognition of revenue. In that regard, we've attached as an appendix to this submission Position Paper PP017 which details our association's stance on the issue. We draw your attention to the list of suggestions offered on pages 3 and 4 which set out a typical list requirement of minimum requirements. To summarize, a surety underwriter will look for the following information to be provided with or as an adjunct to the contractor's financial statement:

Detailed notes to the financial statement which clearly articulate and describe in detail the revenue recognition policy.

- A schedule to be included with the financial statement which details the status of each job in progress at the statement date. Such schedule should include:
 - o Revised Contract Price including any and all approved change orders.
 - The original estimate of job cost and gross profit.
 - Amount invoiced to the client.
 - Total job cost to date.
 - Estimated cost to complete.
- A second schedule which details the status of jobs completed during the fiscal period. This schedule should include:
 - Final contract rice
 - Final job cost and gross profit
 - Job costs incurred and gross profit earned during prior fiscal period(s)
 - o Job costs incurred and gross profit earned during the current fiscal period
- Appropriate balance sheet treatment of over and under billings where applicable. The amounts shown on the balance sheet should be easily identifiable from an analysis of the two schedules discussed above.

This brings us to the key issue of the relative cost/benefits of developing this information for disclosure purposes. We believe that the ultimate cost differential between a presentation which includes the level of detail described above; and one that does not, may be minimal for two reasons:

- 1) For our industry, a comprehensive understanding of a contractor's revenue recognition approach is of such fundamental importance that sureties will typically insist that their clients produce this information; whether or not it is included in the auditor's presentation. This will invariably require staff and senior management of the entity to invest inordinate amounts of time and resources to compile the data needed to provide their surety with the required level of certainty. Often these efforts necessitate the involvement of the auditor as well as they would already have acquired much of the requested information during their review.
 - When one takes into account the cost; both in man-hours and monetary resources (not to mention frustration level) to develop this information after the fact, it stands to reason that the "savings" realized by not taking the disclosure route would be minimal at best.
- 2) We've heard the concern that full disclosure as set out in the Exposure Draft would impose an undue burden on small to mid-sized entities. The argument goes that such firms may lack the resources and sophistication to implement the systems needed to access the required information. We respectfully suggest that this argument very much overstates the case.
 - The technical requirements needed to produce the data are to say the least; not sophisticated and would be within the capabilities of even the most rudimentary accounting system; perhaps with a small up-front, one-time system upgrade. Much of the data should indeed be accessible on the client's existing system, and the cost of becoming compliant should be negligible; even for smaller firms.

Other Issues for Discussion

In addition to the questions posed, SAC has identified other components of the revised Exposure Draft which we believe are worthy of commentary:

A Contract as an Integrated Obligation: One of SAC's most pressing concerns with the June 2010 Exposure Draft was the segmentation of construction contracts into component "performance obligations". While the "performance obligation" concept has been retained, we are very pleased to note that paragraphs 28 & 29 address the concern of the construction sector. These provisions allow goods and services that are "interrelated" and integrated "...into the combined item(s) for which the customer has contracted" to be treated as a singular performance obligation. Our only concern surrounds the use of the term "customer" as discussed above in our response to Question 1.

Retrospective Application: we were somewhat disappointed to see that the boards had elected to retain the requirement for retrospective application of the new standard. Despite the practical expedients outlined in Paragraph 33, we repeat the concerns outlined in our letter of October 19, 2010 that this will approach will increase costs without providing any commensurate benefit.

Summary / Conclusion

Again, we at the Surety Association of Canada wish to express our gratitude to the boards for the time and effort expended to understand and respond to the issues we raised. As indicated, our two most pressing issues; the recognition of the construction contract as an integrated obligation and the transfer of control over time have been addressed in a workable fashion and (subject to that one suggested modification) should work well going forward.

We believe as well that the disclosure requirements will ultimately work to the benefit of all parties and eliminate much of the costly, labour intensive and frustrating follow up work that is currently being done to understand the true meaning of the financial statement.

As before, we thank the boards for the opportunity to provide our comments and would be happy to elaborate on any of the points discussed herein.

Yours Very Truly,

Steven D. Ness

President,

Surety Association of Canada



INDUSTY POSITION PAPER #017

Reporting of Revenue on a Contractor's Financial Statement

Surety companies often encounter a serious problem in the reporting of revenue on a contractor's financial statements. Imprecise reporting standards have led to serious discrepancies in revenue recognition and in many cases; the contractor's profitability is materially misstated. It is the position of the Surety Association of Canada that revenue should be recognized using the "percentage of completion" method as determined by comparing cost-to-date to estimated total cost of the project.

Surety companies have long been aware of a serious problem in the reporting of revenue for construction contractors in Canada. The association believes that the problem can be traced to directions provided in the C.I.C.A. Handbook which are sufficiently vague as to allow a wide variety of interpretations and may lead to the provision of financial information which is misleading.

We refer in particular to **Section 3400** which deals with the issue of revenue recognition. **Section 3400** offers the following definitions for the Percentage of Completion Method:

A method of accounting that recognizes revenue proportionately with the degree of completion of goods or services under contract.

With respect to construction contracts and other long term obligations, **Paragraph 3400.08** attempts to place a finer point on the definition by stating:

In the case of rendering services and long-term contracts, performance should be determined by using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.

While this seems appropriate enough as a general guideline, its value as a working directive to accounting practitioners in the construction industry is questionable. Specifically, we believe that the accounting standards do not provide enough guidance as to the way in which the percentage of completion method should be applied, and that using billings-to date as a measure of completion may be inappropriate for revenue recognition purposes. Industry experience indicates that contractors and their accountants frequently focus on billings-to date to determine to determine a project's progress. This approach usually has the effect of front ending profit recognition and can materially distort the true profit based on a proper matching of costs and revenue.

This is not an issue of simple non-compliance. In discussing the issue with C.A.'s who offer such audit opinions it appears that they truly believe that they are in full compliance with **Section 3400** as written. Reviewing the language used in **paragraph 3400.08** this assertion would seem to have merit. Indeed a reasonable individual can conclude that "reasonable assurance" as to performance exists when a customer or their representative (architect or consulting engineer) approves the contractor's invoice for payment, notwithstanding that such an approach can seriously distort a contractor's financial picture.

To illustrate the nature of the dilemma, consider XYZ Construction Ltd. which at its fiscal year end had one job in progress as shown:

XYZ Construction Ltd.

	Original					Remaining
	Contract	Estimated		To Date		Costs to
<u>Job</u>	<u>Price</u>	<u>Cost</u>	<u>Profit</u>	<u>Billings</u>	<u>Costs</u>	<u>Complete</u>
1	\$1,600,000	\$1,400,000	\$200,000	\$1,000,000	\$750,000	\$750,000

Employing the "Cost-to-Cost Percentage of Completion Method", the job is 50% complete at year end and has generated revenue of \$800,000 with a gross profit of \$50,000. The balance sheet will include a \$200,000 allowance for "Billings in Excess of Costs and Estimated Earnings" shown as a current liability.

By contrast, the" *Billings-to-Contract Price Percentage of Completion Method*" will yield a different and a slightly distorted revenue picture. Using this method, the job is 62.5% complete at year end and has generated revenue of \$1 million with an earned gross profit of \$62,500; \$12,500 more than would be earned under the cost-to-cost method. Using this method, \$188,000 would appear as a current liability on the balance sheet to reflect the amount "over billed" to the project owner. If a project is over-billed, this method of revenue recognition will result in profits being earned quicker than the cost-to-cost method. Alternatively, if a project is under-billed profits will be earned slower than the cost-to-cost method. In the end, both methods of revenue recognition will converge to an identical earned profit amount once the project has been completed.

An even more distorted picture emerges when the "*Pure Progress Billings Method*" is applied. Under this method, revenue is recognized at the moment the invoice is submitted to the project owner with no regard to the true extent of completion of the physical work nor any balance sheet allowances for overbilling. Revenue is now \$1.0 million with \$250,000 in gross profit, despite the fact that as the job proceeds to completion, the lion's share of these "profits" will disappear to arrive at a final gross profit of \$100,000.

Field experience suggests that the practice of using billings-to-date as a measure of project completion is widespread. During the course of earlier discussions with C.I.C.A., the Surety Association of Canada contacted underwriters from the largest bonding firms in the industry. These underwriters were asked to choose ten files at random with statements purportedly prepared on the percentage of completion basis. On average less than 50% were actually prepared using the *Cost to Cost Percentage of Completion Method*. Most were prepared under the *Billings to Contract Price Percentage of Completion Method* method and some even using the *Pure Progress Billings Method*.

.While many accounting firms have their own more detailed guidance and many make use of other authoritative literature (e.g. Skinner - Accounting Standards in Evolution and The A.I.C.P.A. Auditing and Accounting Guide for Construction Contractors in particular), many it seems do not. To its credit, C.I.C.A. has recognized the seriousness of this dilemma. In January 1997, The Emerging Issues Committee published EIC-78 Construction Contractors — Revenue Recognition When the Percentage Completion Method is Applicable. This abstract articulated the problem in more detail and directed practitioners' attention to the authoritative sources mentioned above. Despite this laudable effort however, surety personnel continue to observe a preponderance of financial statements which purport to be prepared under the percentage of completion method, but are in fact using some variation of a billings/accrual basis of revenue recognition

The Surety Association of Canada urges contractors and accounting professionals to adopt the revenue recognition method that most accurately reflects the measure of completion of projects in progress. We suggest that in the majority of cases this will be the *Cost to Cost Percentage of Completion Method*. We believe as well that revenue recognition methods that distort the true profit picture such as the *Pure Progress Billings Method* should be avoided.

Finally, the Surety Association of Canada believes that the establishment and enforcement of a more thorough approach to recognition of construction revenue is in the interest of all parties. In that regard, the following suggestions are offered:

- Accountants provide a clearly articulated and detailed description of the revenue recognition policy in the notes to the financial statement.
- A schedule should be included with the financial statement which details the status of each job in progress at the statement date. Such schedule should include:

- Revised Contract Price including any and all approved change orders.
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- > Appropriate balance sheet treatment of over and under billings where applicable. The amounts shown on the balance sheet should be easily identifiable from an analysis of the two schedules discussed above.

To operate effectively in today's competitive marketplace, a contractor needs a healthy relationship with their surety, bank and other creditors. Detailed and thorough financial information with appropriate treatment of revenue recognition will enhance a surety's confidence in a contractor's operation and will go a long way toward helping the firm meet its business objectives.

For More information, readers are encouraged to visit the Surety Association of Canada website at www.suretycanada.com, or contact the association directly at 905-677-1353 or surety@suretycanada.com.

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.