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AGC of America
THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA
Quality People. Quality Projects.

June 19, 2009

Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

RE: Preliminary Views on Revenue Recognition in Contracts with Customers

In response to your discussion paper on Preliminary Views on Revenue Recognition in Contacts with Customers released December 19, 2008, I am submitting the comments as set forth below on behalf of the Associated General Contractors of America.

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 33,000 firms, including 7.500 of America's leading general contractors, and over 12, 500 specialty-contracting firms. Over 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. AGC contractors are engaged in the construction of the nation's commercial buildings, manufacturing and industrial facilities, public infrastructure, multi-family housing projects, site preparation/utilities installation, and more. The construction industry represents 8% of the US gross domestic product.

We appreciate the efforts of the Boards and their staff in preparing the Discussion Paper and for the opportunity to comment on the proposed principles.

The construction industry is made up of entities that are very simple and have well defined contracts that are performed over a relatively short period of time to complex structures that perform contracts that take months and sometime years to complete. In most cases, every contract is unique. The contractor has never built the exact project under the same terms and conditions before and will never build it again. This characteristic is important in evaluating revenue recognition because construction contractors, along with shipbuilders, aerospace companies, etc. have inherent risk which places substantial reliance upon estimates in measuring periodic revenue recognition. It is important when developing a principle for the principle to be one that is easily understood and easily communicated to the user of the financial statement. It is also important for the treatment of a transaction to be predictable by both the preparer and the user.

After 28 years of applying the principles and guidance of SOP 81-1, the construction industry preparers and auditors along with the users of its financial statements have substantial compliance with the standards. AGC believes that the practices are both accepted and applied in the industry and the principles produce faithful representations of the financial condition and results of operations of construction entities. We disagree with the statement in paragraph 6.3 that "the proposed method would not significantly change how entities recognize revenue for many long-term contracts". As these comments display, AGC believes that the proposed method when taken in a whole will result in substantial changes in the timing of revenue recognition in the construction industry.

While we have provided answers to the questions raised in paragraph S 34, we request that long-term construction contracts be exempt for the proposed principle. AGC requests your consideration of a separate revenue recognition standard that is aligned with SOP 81-1. Certain concepts outlined in SOP 81-1 require revisions or updates for new business and contractual arrangements not contemplated when originally issued,

Alternatively, AGC believes that a valid test of any new principle that is intended to replace the guidance of SOP 81-1 should be tested against the outcome of SOP 81-1. If the revenue recognized in a given period significantly differs from that which would be recognized under SOP 81-1, it is likely that the principle is flawed.

The majority of contracts which our members construct are produced on property they do not own and therefore the service or property is continuously and contemporaneously being transferred from the contractor to the owner. Our comments that follow generally assume the customer has control of the asset.

As SOP 81-1 has been generally accepted and implemented in US accounting for performance type contracts, we believe that its principles should be retained in any new principle(s) intended to replace SOP-81-1. Below is a compilation of fundamental concepts that underpin the measurements in SOP 81-1 that should be retained.

- With limited exceptions, the performance obligation should be defined as the total contract including any modification to terms and scope. The division of a single legal commitment into multiple performance obligations creates complexity, lack of predictability, and potential for manipulation with limited, if any, improvement in the faithful presentation of financial transactions.

- The margin of a contract should reflect the overall profit objective estimated for the contract unless the contract or performance obligation is appropriately severed.
- Contracts should be remeasured as changes occur in scope of the work through change orders, change directives, claims, incentives, etc.
- Revisions in net contract positions should be recognized under the catch-up concept rather than future periods. This is consistent with the concept that a contract has a single profit objective although multiple margins may exist on performance components that do not rise to the level of a separate performance obligation
- Measurement of progress in the performance of the contract should be verifiable and not based solely upon management assertions
- Losses should be recognized in full in the period that they are identified.
- Revenue should be recognized as performance progresses under the percentage of completion method applying measurements described in SOP 81-1 as either Method A or Method B or as described in IAS 11.
- Costs should be defined in such a manner to provide consistent comparability of financial results including cost elements to be considered when a loss (onerous) contract measurement is required.

Below we address the questions that are listed in paragraph S34 of the Discussion Paper.. AGC will limit its answers to questions where the subject matter relates to types of transactions that are frequent in the industry and/or enterprises that perform construction contracts. While the Discussion Paper indicates that general practice for long-term construction contracts will not have substantial change under the revenue recognition principle, we disagree and believe that the new principle will have substantial changes from current practice and will increase the likelihood of abuse and misstatements.

Question 1

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

AGC does not agree that a single revenue recognition principle is necessarily a meaningful enhancement of GAAP. It seems counter-intuitive that in a society and economy where transactions are increasingly complex, imaginative, and litigious that moving from measurements that address the very nature of the transactions to measurements that are limited to single criteria is an improvement. These continuing complexities in revenue transactions seem to dictate more than one revenue recognition principle. At a minimum, subsets from one revenue recognition principle should be created where the subsets consist of unique industry specific or transaction specific revenue recognition principles. It may be appropriate to exempt certain industries or transactions from certain revenue recognition principles to more accurately reflect the satisfaction of obligations and at the same time reduce the number of revenue recognition methods currently applied. To the extent the industry or type of transactions can be combined and achieve the objective of less revenue recognition methods utilized and more accurate revenue recognition will be achieved.

We do not believe that a single revenue recognition principle can be developed that expeditiously measures simple contracts such as examples on typical retail sales and at the same time addresses the complexity in large construction projects.

The percentage of completion method of accounting is a prime example of how the Board's definition of revenue based upon changes in the entity's contract assets and liabilities does not work. Under the percentage of completion, the contract billing is adjusted for revenue in excess of billings or billings in excess of revenue which resulting adjustment is an asset or liability, respectively. One cannot measure this asset or liability without first quantifying revenue.

This then provides the answer to the fundamental question of a single revenue recognition principle. While it may be appropriate for the Board to reduce the vast number of recognition methods recognized by US GAAP, at most their guidance should be a preference to the change in assets and liabilities with the alternative of other measurements if they are more precise, effective, and cost beneficial.

The measurement of assets and liabilities associated with a given contract or deliverable element of a contract may provide meaningful data for elements used in the ultimate measurement of revenue, including the measurement of the percent complete. So the concept has its place in standards but should not be the sole method of measurement of revenue. You will see other examples of how the asset and liability measurement method produces results that are not faithful to recognition in the construction industry in comments later in this letter.

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?

AGC does not believe that the proposed principle will be consistently applied for similar transactions. The concepts of what constitutes a performance obligation, customer control, etc. are subject to substantial interpretation. Intentionally or unintentionally, the finance reporting may not result in consistent, accurate, or appropriate reporting of revenue. Audit firms will be "shopped" to find those that will concur with the allocations. Credit grantors like banks and sureties will be disenfranchised.

The concept that in most cases a contract is a single profit center as presented in SOP 81-1 is a valid position. The conditions under which a contract can be combined or severed into multiple "performance obligations" should be difficult to support. The standards of the position paper for this decision are substantially subjective. This will lead to massive inconsistency in reporting and we fear encourage aggressive, or worse, fraudulent reporting.

Additionally, we do not believe that the proposed principle provides management with information that it will find useful, or an improvement over the data currently available in measuring performance. We suspect that many companies will continue to use current practice to manage their companies which are based on cost management, profit, and return on investment, not revenue recognition. The reporting and measurements represented by the proposed principles in the discussion paper will add internal administrative costs and create only isolated financial reports that few will use in any effective way.

Should the Boards continue with the proposed principle, we would hope that the definition of a performance obligation should include only major components or phases that are substantially different from other obligations. For example, SOP 81-1 currently provides no guidance on the reporting of a contract that requires the contracting entity to design the project, procure the property, construct the property, and operate the facility. Sometimes financing is another element of the contract. Each of these major activities has different risks and may have very different margin objectives. Severing a single contract into many performance obligations will result in complexity that does not add to consistency and faithful reporting.

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.

The definition "A contract is an agreement between two or more parties that creates enforceable obligations" is a reasonable definition.

We question the rationale state in paragraph 2.14 that does not require the agreement to be in writing. How can an entity have any confidence in its assessment of the performance obligations that are created in an agreement that is not reduced to writing? How will an auditor ever be satisfied that the contract assets and liabilities are all accounted for?

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.

The performance obligation of a construction contract generally is to provide a single project in a completed and functional form. Contractors may interpret the performance objective of the project in its entirety at the end of the contract period subject to the owner's satisfaction and acceptance. Contractually establishing deliverables or phases of the product provided may be another interpretation subject to judgments (potentially inconsistently applied) or to contract terms.

The judgment of the contractor, the contract terms, and many other factors are subjective. This subjectivity will not lead to consistency and again, intentionally or unintentionally, may lead to inappropriate revenue recognition. Guidance in the components of performance obligations that may be treated as separate measurements will be needed.

AGC has concern that the ability of entities to define components of its performance obligations in such a way as to accelerate the recognition of revenue can result in overstatement of their financial condition and comprehensive income. While a contractor may price performance activities with varying margins reflective of risk and market conditions, in most cases the objective of the pricing is to achieve a composite margin as a return on the overall performance of the entire contract.

As way of example, a general contractor may have a contract that has the following summarize pricing –

Component	Cost	Margin (Markup)
Mobilization	$300,000	30%
General Conditions	$800,000	15%
Self performed construction	$1,000,000	25%
Materials	$2,000,000	2%
Subcontracts	$6,000,000	5%
	$10,000,000	
Composite Margin	$800,000	8%
Total Contract	$10,800,000	

The contract has a value of $10,800,000 and the general contractor and owner have agreed on a schedule of values against which the contractor's performance will be billed using the above pricing. Recognize that the schedule of values may not be the true value of the objective to the owner or the value the contractor believes it has provided. It may only be a funding schedule for the project.

Under the model proposed, mobilization could meet the definition of a service performance obligation that is met when the general contractor has set up its operations on the site of the project. AGC does not agree that an entity should be allowed to recognize $90,000 of margin. Under current measurement, the contractor would recognize the contract as 3% complete and revenue of $324,000 would be recognized with costs of $300,000 and margin of $24,000 and the balance sheet would reflect billings in excess of revenue of $56,000 because the schedule of values allowed the contractor to bill $390,000.

The current measurement is supported by contract law that would only allow the contractor an 8% markup if the contract was terminated by one of the parties. Some jurisdictions would require a contract to return the funds advanced in excess of revenue recognized under the current percentage of completion method if the contract in the example above was terminated.

It is common in the construction industry for contracts to contain provisions that are designed to enhance cash flow in addition to those that enhance revenue and profit. Examples such as the mobilization obligation listed above or the ability to bill for uninstalled materials at a job site could influence the decision to recognize the satisfaction of a performance obligation under the proposed standard.

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 asset to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?

It is reasonable that the transfer of property to a customer is a valid point in time to measure a performance obligation. We do not agree that every transfer should be separately measured. A more faithful measure of the operations of an entity may be better expressed in measuring a group of items that are transferred in a reasonable proximity of time.

As fully presented in the discussion paper, most construction projects transfer property continuously.

AGC does not agree that a separate performance obligation should be measured if there is not an observable support for the allocation of the contract asset. The proposed principle to estimate this allocation adds another estimate and consideration of judgment subject to interpretation that invariably will materially enter into the determination of the financial condition and result of operations of the entity. For long-term contracts under the proposed principle, reporting will encompass estimates for the allocated asset, the allocated costs to completion, and the measurement of partially satisfied performance obligations (the percent complete). We recommend principles that minimize rather than expand the use of estimates in measurement.

Question 6

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

This type of transaction is not common in construction companies and therefore we have chosen not to comment.

Question 7

Do you think that sales incentives (for example, discounts on future sales, customer loyalty points, and "free" goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?

This type of transaction is not common in construction companies and therefore we have chosen not to 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 service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.

The transfer of an asset to a customer will normally demonstrate at least a partial satisfaction of a performance obligation. The transfer may not of itself support the position that the obligation is completely and fully satisfied. Other factors that are typical in construction contracts include acceptance provisions of contracts. Acceptance may include the project functioning on its intended or designed purpose or level. For example, it is common in power plant construction for the contractor and/or engineering company to have variable compensation based upon the power output of the facility.

Standard processing in the construction industry is that owners hold retention – typically 5% to 10% of the billings to date – and even though elements which might be categorized as performance obligations are tendered to the owner, the retention continues to be held until completion of the project.

AGC believes that transferring a contracted good or service is evidence of a performance obligation being satisfied but that alone should not be determinative. For example, the satisfaction of a performance obligation should include the contractor meeting the plans and specifications of the contract. While the property my be transferred under local law, the obligation is not fully satisfied.

The Boards should also give consideration under this principle that in construction there may be multiple tiers of subcontractors working under agreements with a general contractor to construct a property on an owner's site. The services of the subcontractor is being continuously transferred to the owner who is not the subcontractor's customer, nor is the subcontractor in privity with the owner. Under normal contract terms, both the general contractor and the owner must be satisfied that the performance of the subcontractor meets the specifications before the obligation is completely satisfied. Could a general contractor accelerate recognition of a portion of its contract with an owner that is being performed by a subcontractor based on the fact that the subcontractor has provided a performance and payment bond to the general contractor?

Similar to the multi-tiered specialty contracts are many joint venture agreements. A joint venture entity enters into a construction contract agreement with an owner. The venture then awards some or all of the actual performance of the contract obligations to the separate venturers. Under the proposed principle do all of the parties recognize performance obligations as being satisfied at a simultaneous moment? Or do they satisfy their performance obligations at different times?

Question 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.

AGC supports the recognition of proportionate revenue under the percentage of completion method as partial satisfaction of performance obligations are satisfied similar to current practice under SOP 81-1.

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?

AGC does not agree with this model. Construction contracts are frequently entered into with incomplete plans and specifications. Additionally, over the life of the contract, owners identify changes in scope or quality of the components in a project. Owners may delete items from a contract or modify the production schedule to meet new conditions. Lenders may impose new restrictions under the contract well into the production process. None of these events may meet the proposed standard of "onerous" but either individually or collectively have significant impact on the value and margin of the contract.

The current model that is used in the percentage of completion method whereby the estimated value of the contract, estimated contract costs at completion and estimated margin are remeasured in each reporting period should be the standard. If an entity can support that the changes are not material, then as with all standards, they would not make adjustments. AGC believes the Boards have this standard backwards. The standard should be to remeasure with the exception for immateriality and not a standard on not remeasuring unless the changes are "significant" – whatever that means.

(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?

AGC agrees that contracts should be remeasured when they are deemed onerous.

(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.

As stated elsewhere in this document, AGC supports frequent remeasurement and any adjustments being reflected using the catch-up method described in SOP 81-1.

(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

As previously stated, AGC supports frequent remeasurement. However, the measurement criteria should be consistently applied within an enterprise.

The allocation of a portion of the contract asset to a warranty element adds an element of complexity to revenue recognition that we do not support. Warranty is better measured as a cost accrual rather than a revenue allocation. For the construction industry, the amount of warranty on a given contract at completion is less than 1% of the contract. Keeping the contract reporting open for a warranty tail of recognition complicates the reporting for contractors with no meaningful contribution of decision-useful information for the users.

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 customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize 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 contract should be included in the initial measurement of an entity's performance obligations? Why or why not?

The construction industry does not typically charge a fee to recover selling costs. However, precontract services often are provided on the basis of a fee arrangement that is not contingent upon the parties reaching an agreement to construct. On occasion, these agreements "roll into" a subsequent construction contract. Under current standards for preconstruction costs, the excess unreimbursed costs may qualify for capitalization. If not, the costs would be treated as a period cost.

AGC does not agree that the cost of obtaining the contract is an item to include in the initial measurement of an entity's performance obligations unless there is an expressed agreement for the services.

(b) In what cases would recognizing 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.

It is not uncommon on the complex construction projects being developed today for a team including a developer, designers (architect and engineers), a general contractor, and certain major specialty contractors to incur substantial costs defining a project. The recent expansion of BIM systems is an example of this. Many of these projects fall within current standards that permit the costs to be capitalized because a future contract is probable.

AGC believes that current standards should be retained in future principles.

Question 12

Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's standalone selling prices of the goods or services underlying those performance obligations? Please provide examples and explain why?

If a contract is severed for multiple performance obligations, observable standalone selling prices is a valid method for measuring each obligation. However, we reiterate AGC's preference to treating a contract as a single performance obligation with an overall profit objective.

Question 13

Do you agree that if an entity does not sell a good or service separately, it should estimate the standalone 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?

As previously discussed, many contractor performance obligations do not have any verifiable or observable standalone selling prices. AGC believes that introducing the element of estimating the standalone prices under these circumstances creates a risk of misstatement that should be avoided. Any improvement form applying the proposed principal in our view will not offset the greater risk of misstatement.

Other Comments

Dependence on Estimates
The construction industry and users of its financial statements are both experienced with and comfortable with the impact that estimates play in revenue recognition. We believe that many industries that may currently have contracts with customers and eventually come under the proposed principles may not have the tolerance of the variance that arises in the use of estimates for revenue measurement. AGC is concerned that as the final concept is adopted after input from all constituents that the final model will significantly alter what has become accepted practice in the construction industry whether referring to GAAP or IFRS.

Cost Accounting
AGC believes that the Boards should expand the revenue recognition project to provide more deliberation on what constitutes costs under a contract and the period in which these costs are reported. Over 75% of contractors use contract costs as the measure of the percent complete. Inconsistent allocation of costs to contracts will result in similar contracts being subject to remeasurement under the onerous standard while entities with less inclusive allocations would assert that the contracts were not onerous. As discussed in paragraph 5.67, the guidance for cost accounting should be issued prior to any revision to the revenue recognition model.

Sincerely,

Jeffrey D. Shoaf
Senior Executive Director
Government and Public Affairs