



**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**

*The Source and Resource for Construction Financial Professionals*

**October 21, 2010**

**Financial Accounting Standards Board**

401 Merritt 7  
PO Box 5116  
Norwalk CT 06856-5116  
Attn: Technical Director – File Reference No. 1820-100  
(Via U.S. Mail and Electronic Mail)

**Re: CFMA’s Comments on the FASB and IASB’s Exposure Draft  
on Revenue Recognition from Contracts with Customers**

The Construction Financial Management Association (CFMA) is pleased to provide its response to FASB and IASB’s Exposure Draft on Revenue Recognition: Revenue from Contracts with Customers (hereafter, “Exposure Draft”).

CFMA is uniquely focused in its representation of the financial interests of the construction industry. Our membership is comprised entirely of financial statement issuers, auditors, and users within the construction industry. As such, CFMA is particularly qualified to supply FASB and IASB with feedback as they work to establish accounting standards that impact our industry.

We applaud the Boards on their efforts to improve financial reporting with respect to revenue recognition. CFMA appreciates that there is tremendous divergence in practice that can vary by industry; numerous rules that can sometimes present conflicting guidance; gaps in current literature; and a need for clearer principles that can broadly apply to numerous industries in order to achieve more consistent reporting of transactions with customers. We also fully support efforts to achieve convergence with international standards.

Further, we appreciate FASB’s outreach to all industries as it deliberates this proposed standard. We also appreciate the opportunity CFMA has had to participate in those deliberations. From our participation, we know the earnestness of the Boards’ desire to achieve the noble outcome of creating a single, high-quality standard on revenue recognition that will apply to substantially all transactions with customers and to substantially all industries.

**Desire to Retain Revenue Recognition Model as Provided for in SOP 81-1 (ASC 605-35)**

Notwithstanding our appreciation for the efforts underway to improve revenue recognition rules, it is vital for the Boards (and FASB in particular) to know clearly and unequivocally, that **the financial reporting model for revenue recognition for the construction industry works incredibly well for all of our constituents.** There is not a single contractor, surety, banker, or auditor with whom we have spoken that supports the repeal of SOP 81-1 (ASC 605-35) in favor of a new comprehensive revenue recognition standard. The recurrent theme we hear from those we represent is that FASB shouldn’t be trying to fix something that isn’t broken!

We believe that any effort to improve revenue recognition for the masses will result in a standard that is a step backward for the construction industry. Even though we know that the Boards previously considered and rejected this request, **it is imperative that we, once again, ask the Boards to exempt the construction industry from the new standard.** Further, should our request be heeded and should SOP 81-1 need to be converged with IAS 11 and IAS 18, it is our strong desire that in any points of divergence between these standards, the tenets of SOP 81-1 should prevail.

The Boards should consider what the construction industry has achieved with its revenue recognition model: An approach with an almost universal acceptance and application. Not only does SOP 81-1 work well for external financial reporting purposes, but the IRS has modeled its regulatory requirements for the PCM to be almost identical to SOP 81-1. Perhaps even more importantly, it is THE standard of measure in internally generated financial statements used by management. When SOP 81-1 was issued, those standard setters “got it right.” Any effort that would undermine key tenets of SOP 81-1 would only be a step backward for our industry.

### **Structure and Areas of Focus in Our Response**

CFMA’s response letter seeks to provide meaningful and constructive input, with our only objective being the preservation of high-quality financial reporting for the construction industry. Though our strongest and overwhelming preference is for the construction industry to be exempt from a new standard altogether, we recognize that our failure to provide appropriate input could leave us being subjected to a new standard which doesn’t meet the needs of our industry in any way.

For this reason, we are providing detailed feedback based upon information in the Exposure Draft. Our comments, not surprisingly, are framed within the spirit of SOP 81-1 and we ask the Boards to interpret the application of the proposed rules to the construction industry through the screen of SOP 81-1.

Our comments, in order of magnitude, are focused on the following elements of the Exposure Draft:

- Identifying separate performance obligations
- Determining the transaction price
- Continuous transfer of goods and services
- Transition

### **Identifying Separate Performance Obligations**

The Boards have already heard significant input from construction industry reporting entities, auditors, and users of financial statements expressing their concerns regarding the identification of separate performance obligations within a contract. Undoubtedly, the failure to “get this right” will result in real and substantial adverse economic effects within the construction industry.

We affirm the concerns of our industry that are articulated very well in paragraph BC46. We also appreciate the Boards’ consideration of the concerns of all industry groups and its desire to resolve those divergent concerns through its approach, as discussed in paragraphs BC48 and BC49.

We specifically concur with the concept that an entity should account for a promise of a good or service as a separate performance obligation only if that good or service is distinct (BC48). We also concur that the best evidence that a good or service is distinct is when the good or service is sold separately (BC49). It is our overwhelming preference that the guidance for identifying separate performance obligations should end at this point and avoid the entire notion of hypothetical transactions.

We fundamentally disagree with any philosophy that dictates that you must make hypothetical assumptions in order to account for a real transaction. By default, a hypothetical transaction (at worst) lacks economic substance and (at best) carries

the significant risk that real economic consequences are overlooked. Moreover, it seems highly counterintuitive to rely on hypothetical transactions in order to have a basis for identifying separate performance obligations within a given contract. Any attempt to segment one contract into multiple performance obligations fails to account for the economic reality of the inherent, inseparable risks of that contract.

The Exposure Draft, as it is written, runs the risk of ignoring these economic realities in its guidance for identifying separate performance obligations. And, here's another critical consideration: Any process for identifying performance obligations that relies on a hypothetical transaction is highly subjective and fraught with opportunities for manipulation.

We should not bend reality to fit accounting ideology. Instead, we should rethink the ideology and fit it to economic reality.

Notwithstanding our substantial objections to applying a hypothetical version of reality to a very real economic transaction, we recognize that the criteria outlined in paragraphs 23(a), 23(b)(i) and 23(b)(ii) are directly the result of the Boards' efforts to address divergent industry concerns. Therefore, in spite of strong reservations surrounding the wisdom of this approach, if there is no better way to resolve these divergent industry concerns, then, in the spirit of advancing a solution that does not jeopardize the fundamental notion of a single, high-quality standard to apply to substantially all industries, we do believe that these criteria can be operational for the construction industry if they are interpreted appropriately, but current guidance will need to be reconsidered in certain areas, as follows:

#### Distinct Profit Margin Considerations

While we concur with the Boards' reasoning in paragraph BC53 that requiring an entity to estimate a selling price for a good or service that does not have a distinct profit margin might result in information that is not useful, we would like to amplify our concern that it is quite likely to result in information that is fundamentally misleading.

We strongly concur with the association between the concept of distinct profit margin and the guidance in Subtopic 605-35 (herein as referred to as SOP 81-1) on segmenting a contract as suggested in paragraph BC54. In fact, our preferred method for identifying separate performance obligations would be to carry over the tenets from the segmenting guidance in SOP 81-1 into any new standard. Why? Because SOP 81-1 has adequate safeguards built into its criteria that significantly limit subjectivity and opportunities for manipulation. These criteria recognize that unless you can demonstrate a strong market basis for subdividing a contract, it should not be subdivided. The guidance in SOP 81-1, which is fully operational, virtually eliminates the risk of permitting the accounting for a transaction to become separated from its economic reality.

We also agree with the Boards' conclusions in paragraph BC55 that indicate that an entity would only have a basis for estimating a selling price if the good or service is subject to distinct risks and the entity can separately identify the resources needed to provide the good or service. We agree with the last sentence of this paragraph if it is interpreted to read:

Otherwise, the entity typically would not sell a good or service separately – *not necessarily* because it lacks a distinct function (though it could), but because *the good or service lacks distinct and separable risks*.

However, if our interpretation is not consistent with the original intent of BC55, then we take exception to the guidance in the last sentence of this paragraph, since we have noted above how the guidance should be framed.

We believe that the Boards are leaning in the right direction in the guidance contained in paragraph BC56; however, where the guidance currently reads, "For example, in *some* construction contracts..." we believe that this guidance should read "For example, in *most* construction contracts..."

In fact, we believe that the point the Boards are making in this section of the Exposure Draft is the most critical concept in attempting to ascertain if more than one performance obligation exists in a contract. Specifically, the example given in BC56/57 recognizes that construction tasks are highly interrelated and that subcontracting, in and of itself, does not result in the satisfaction of those risks. Specifically, we agree that even though separately identifiable tasks may exist, there are risks

that exist which are inseparable. Within the confines of the proposed standard, we believe the Boards' philosophical conclusion on this matter is very sound and well-reasoned as presented in this section of the Exposure Draft.

Further, we believe, as the Boards apparently believe, that the concepts of inseparable risks and highly interrelated activities are crucial to the identification of separate performance obligations. Because these concepts are so critical to the proper application of the guidance in paragraph 23(b)(ii), we believe that the concepts of inseparable risks and highly interrelated activities should be introduced and incorporated into the main body of the standard. These concepts are too important for their introduction to be relegated to the "Implementation Guidance" or "Basis for Conclusions" sections of the standard.

### Example 11

Turning our attention to Example 11 at paragraph IG43, we concur with the Boards' continued focus of seeing separate performance obligations through the lens of interrelated activities and inseparable risks. However, we believe that the Boards have reached erroneous conclusions in applying their own philosophically sound ideology to the facts of this example.

Specifically, the Boards conclude that, "The design services are distinct because similar services are sold separately by the entity and its competitors." Yet, the Boards conclude that, even though the customer could contract separately with other entities to perform certain other tasks (what we will refer to as "trade tasks"), the trade tasks are not separate performance obligations because they are highly interrelated with construction management services (hereafter, "CM services") and the risks are inseparable between the trade tasks and the CM services.

To appropriately apply the Boards' ideology to this example, you have to start by asking whether the design services are highly interrelated with the other services in the contract (e.g., the CM services) and whether the design services contain risks that are inseparable from the risks related to the CM services or other services under the contract. Without first answering that question, there is a clear contradiction in this Example between the conclusion regarding design services and the conclusion regarding trade tasks.

So, if that is the question that begs to be answered, what is the answer? The incontrovertible truth is that in a design/build contract (or EC contract) – in most, if not all, cases – the tasks associated with design services are highly interrelated with the tasks associated with construction management services and that the risks between these two are inseparable.

Why? First, let's frame this analysis within the context of what we noted previously in our letter – that we have to be very careful in applying the criteria for identifying separate performance obligations lest we reach a conclusion in our hypothetical transaction that is divorced from economic reality. Otherwise, we risk overlooking important economic considerations in trying to identify performance obligations.

The fact is that design/build contracts have evolved into existence over the past 40 years (at an accelerated pace over the past 20 years) because a project owner wants to transfer previously separate risks to a single entity that will be ultimately responsible for ensuring that the design and function work together. Hence, these once previously separate risks have now become inseparable because the design/build contractor now bears this entire burden of risk from concept to completion, and by the very nature of this transaction, bears these risks in an inseparable fashion. The whole reason this transaction exists is to take what were once two previously separate risks and now make them inseparable!

It is also true that design and CM services are highly interrelated because the design services have to support the CM services and in fact, designs are frequently updated throughout the actual construction phase of the project to ensure that design and construction yield the function desired by the customer. These two seemingly separate tasks or services must work in concert during the life of the construction phase of the project to achieve the customer's desired end result. Obviously, if this is true for design and CM services, it is equally true for tasks such as site preparation and site finishing, for contractor oversight in these areas is equally as important as it is for coordinating and managing other trade tasks.

In summary, we concur with the Boards' underlying ideology of inseparable risks and highly interrelated activities, but we believe that the Boards applied their own ideology erroneously in this example. We request that the Boards correct this misapplication of the facts in the final standard.

Of course, if Example 11 is updated, we believe that the guidance in paragraphs BC58 and BC59 should be clarified. While we concur that cases can exist where a contract really represents three distinct performance obligations, we believe that these situations will be much more limited than the guidance presumes. Acknowledgment should be given to the fact that, in limited circumstances, such arrangements may exist.

#### *Further Commentary about Identifying Separate Performance Obligations*

The Boards have already heard significant feedback regarding the concept of separate performance obligations from the construction industry. From our understanding, most of this feedback has been overwhelmingly opposed to the concept of "segmenting" contracts. The reason for these concerns is that the guidance as written (and, in particular, Example 11) fails to appropriately capture the full breadth of the inseparable risks and the highly interrelated activities that are standard within the construction industry. This, in turn, leads to an application of facts that is divorced from economic reality. However, we believe that the vast majority of these legitimate concerns can be addressed by applying the Boards' ideology appropriately to the facts contained in Example 11.

Still, we think it is important to understand the downside risk of not correcting this misapplication of the facts. Our commentary and concerns about applying the standard as currently interpreted follow:

First, there are very real concerns that there will be a loss of credibility in the financial statements due to the significant increase in overall subjectivity in identifying separate performance obligations. **As subjectivity increases, consistency decreases and enhanced opportunities for manipulation enter into the equation.** When this happens, a very real and unintended economic consequence occurs – surety credit tightens for the construction industry in order to counterbalance the harder-to-identify risks that are masked by subjectivity and veiled in inconsistency. (To help enunciate these concerns, we have provided an example as an Addendum to our letter.)

Because we have discussed the Exposure Draft with hundreds of contractors, auditors, and sureties around the country, we have to come to appreciate that even the most earnest individuals who want nothing but accuracy in their financial reporting have significant difficulty in agreeing on how to define the performance obligations within a contract. Something that obtuse is clearly not good accounting. There is no question that, without reform to the application of the guidance in the Exposure Draft, **the quality of financial reporting for the construction industry will diminish substantially.**

Further, contractors – motivated by the fear of adverse consequences resulting from a failure to meet expected financial results – will now be given significantly more opportunity to engineer their financial results based upon the combination of how they define their performance obligations and how they allocate the transaction price to those performance obligations. Though the Exposure Draft attempts to set boundaries to limit such nefarious deeds, the inherent subjectivity introduced into the process makes it much easier for motivated contractors to engineer their way into the results they desire to achieve. Unfortunately, the standard in the Exposure Draft form destroys the integrity of the financial reporting process for contractors.

#### **Determining the Transaction Price**

Participants in the construction industry frequently engage in contracts that provide both incentives for early completion and disincentives for late completion. Sometimes the incentives are binary (i.e., an "all or nothing" bonus arrangement if a specified target is hit). Other times, the bonus or penalty accrues at a rate that coincides with a time continuum (i.e., a fixed amount per day for each day early or each day late). Finally, contractors may share in bonus incentives for controlling project costs and/or can be penalized for the failure to do so (present in many "CM at-risk" arrangements).

While we recognize that the Boards have attempted to provide operational guidance as to how variable consideration should be measured in paragraphs 36-42, we believe that the guidance, particularly when taken in conjunction with further guidance in paragraphs BC81 through BC83, can and will lead to inappropriate accounting.

Specifically, paragraph BC82 indicates that the Boards rejected an alternative of defining the transaction price as an amount that passes a specified threshold because the threshold is seemingly arbitrary and could result in different accounting for similar contracts. However, under the guidance as proposed, that very concern has not been mitigated. In fact, it is almost certain that two contractors with very similar contracts (and very similar experience) will reach different judgments and will thus account for incentives differently, which will result in reporting two different rates of profitability on similar contracts.

So, in fact, the guidance fails to mitigate the concern that different accounting for similar contracts will exist. Moreover, given the relatively thin margins that exist in much of the industry, the profit recognized on incentives yet to be realized can be very material to a contractor's earnings for a reporting period.

While we appreciate the Boards' noble goal of trying to measure the transaction price at the amount the entity ultimately expects to receive, the flip side of this approach is that the door is wide open for substantial swings in estimated earnings based upon incentives that have not yet been realized. Further, while the guidance contained in paragraphs 36-42 is designed to help screen out the inappropriate recognition of incentives, such safeguards do not impose a high enough standard to prevent manipulation of reported financial results by a motivated reporting entity. The auditability of these assertions is extremely difficult, and can lead to substantial differences in judgment between a reporting entity and its auditors.

We strongly disagree with the Boards' conclusion that defining the transaction price as an amount that passes a specified threshold is seemingly arbitrary. To the contrary, it is anything but arbitrary to say that variable consideration will be recognized only once certain hurdles have been cleared. The alternative of estimating a probability-weighted amount to be recognized instead seems arbitrary; and, the feedback we have received from financial statement users indicates significant reservations to recognizing revenue before its realization becomes at least "reasonably assured."

Frankly, it is prudent accounting to impose a threshold of "reasonably assured" prior to recognizing revenue. This is the only way to help ensure consistency and comparability in reported financial results and to weed out opportunities for manipulation and financial engineering.

Similar to the concerns expressed regarding separate performance obligations, we strongly believe that the greater subjectivity introduced by the approach contained in the Exposure Draft related to variable consideration will have a dampening effect on surety credit.

### **Continuous Transfer of Goods and Services and Customer Acceptance**

We generally agree with the guidance related to continuous transfer and customer acceptance as outlined in paragraphs 32 and 33, IG63 through IG73 and BC73 through BC75. However, we believe that there are key concepts from the original SOP 81-1 document that should be carried over as well. While we know that many of these concepts do not apply outside construction-type or production-type contracts, this guidance is still essential in those contexts.

Specifically, the guidance from paragraph 50 regarding uninstalled materials should not be lost under the new standard. While the Boards may believe that they have implicitly dealt with this consideration within the context of paragraph 33(b), it seems logical that some readers could reach a conclusion that costs incurred on materials, whether installed or not, could be counted in the calculation of contract progress. We believe that the Boards should clarify their intentions regarding such costs.

## Transition

Paragraph 85 states that the proposed standard is to be applied retrospectively using the guidance located in ASC 250-10-45-5 through 10. Unless the Boards modify the way performance obligations are defined as we have requested, any attempt to apply the new standard retrospectively will come at an incredible cost, while the utility of information provided is questionable. There needs to be a practical solution to the problems posed by retrospective application. One potential solution is to apply the new standard prospectively as new contracts are entered into or apply a cumulative catch-up adjustment to begin retaining earnings in the most recent year being presented.

## **The Boards' Stated Intent vs. What Appears in Print – A Request that Intentions Be Clarified**

We hope that, at this point, the Boards are reading our letter and saying to themselves, “Well, we certainly do believe that many of the tenets of SOP 81-1 should be retained for the construction industry.” In fact, during our interactions with representatives of FASB (and, to a more limited extent, IASB), we have heard that this is the clear intent of the Boards.

However, they have also inferred that the concerns of the construction industry may be overwrought and that, in particular, the notion of identifying separate performance obligations is intended to be a very high hurdle – and, that in most cases, a project for a contractor to build a freestanding building using third-party designs (i.e., “plan & spec”) should be a single performance obligation (ignoring warranty considerations).

Even when posed with the example of building a high school with all of its various elements – classrooms, gymnasium, cafeteria, auditorium, library, swimming pool, football field, baseball field, etc. – we were assured that even a project such as this would generally be a single performance obligation as long as it follows the traditional award protocols that are common in the U.S. (assuming “plan & spec” and ignoring warranty considerations).

Yet, from a reading of the standard, almost no one would infer that this is the intention of the Boards. For this reason, we believe it is incumbent that the Boards clarify the intended application of the proposed standard in writing so that the stated intent can be clearly inferred from a reading of the standard.

Paragraphs BC241 and BC242 restate the Boards' objectives of achieving consistent and comparable measurements of revenue across transactions and various industries. The Boards must understand that, as currently exposed, the proposed rules applied to the construction industry fail to achieve these objectives. Our industry will be moving away from a method of recognizing revenue that, at least within the industry, reasonably ensures consistency and comparability to a method that does not. This is why it is vitally important that the Boards reconsider the guidance contained in Example 11 and seriously weigh the proposed remedies we have laid out in this letter.

## **The Risks of Failing to “Get This Right” for the Construction Industry**

In this section, we will summarize the very real concerns and fears regarding the impact on the construction industry if contractors are forced to adopt a new standard that departs from the key tenets of SOP 81-1:

- Significant subjectivity in financial reporting is introduced related to the identification of separate performance obligations, determination of the contract price, and the allocation of contract price to separate performance obligations.
- This subjectivity will lead to a loss of consistency and enhanced opportunities for manipulation.
- The loss of consistency and enhanced opportunities for manipulation will lead to a constriction of surety credit.
- To combat a restriction in surety credit, contractors will be led, for business purposes, to seek alternatives to reporting under GAAP.
- Alternatively, internal costs will rise for financial reporting in an industry that traditionally operates on thin margins and at a time when many contractors are operating with almost no margin.

- Contractors will be required to keep multiple sets of books, unlike today when management reporting, external reporting, and tax reporting are all virtually synonymous.
- Software programs will need to be updated to accommodate the segmentation and re-aggregation of contracts to balance the external financial reporting rules with internal management needs.
- External financial reporting costs will increase dramatically due to the risks associated with significantly subjective estimates. In a reasonable number of situations, auditors will be required to engage third-party experts to help evaluate significant subjective assumptions – costs that will be passed along to the contractor.
- Small contractors will be unable to afford to operate in this new environment.

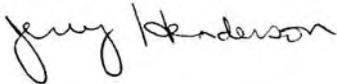
This new environment, as described above, is not one that any rational person would knowingly embrace, and we don't think it is what the Boards intended. But, it is a very real picture of what will happen if the key tenets of SOP 81-1 are not retained. Please "get this right" and exempt the construction industry from the new standard altogether or, if not, ensure that the final written standard clearly retains the key tenets of SOP 81-1.

### **Conclusion**

We sincerely appreciate the opportunity to respond to the Boards' request for comments and look forward to continuing this process in order to help the Boards achieve their objectives of creating a standard that results in consistent and comparable measurements of revenue across different transactions and industries.

The Boards should consider what the construction industry has achieved with its current revenue recognition model. Not only does SOP 81-1 work well for external financial reporting purposes, but the IRS has modeled its regulatory requirements for the PCM to be almost identical to SOP 81-1. Perhaps even more importantly, it is the standard of measure in internally generated financial statements used by management. When SOP 81-1 was issued, those standard setters "got it right." Any effort that would undermine key tenets of SOP 81-1 would only be a step backward for our industry.

Sincerely,



Jerry Henderson, CPA  
Partner, BKD, LLP  
Louisville, KY  
Construction Financial Management Association  
Princeton, NJ  
Co-Chair, CFMA Emerging Issues Subcommittee



Brian Summers  
Chief Operations Officer  
Construction Financial Management Association  
Princeton, NJ  
Staff Co-Chair, CFMA Emerging Issues Subcommittee



**CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION**

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Addendum to CFMA's Response to the  
FASB/IASB Revenue Recognition Exposure Draft:  
An Example of the Potential Impact on  
Construction Contract Accounting

## Separation and Recognition

Performance obligations are defined as promises to deliver goods or perform services. Under current accounting, contractors often account for each contract at the contract level, rather than breaking a contract down into multiple segments or elements. The Boards have proposed that “distinct” performance obligations should be accounted for separately. Accordingly, current practice is likely to change.

However, the application of the proposed separation (i.e., distinct) principle remains unclear for long-term contracts and could lead to diversity in practice, a result that would run counter to the primary objective of providing consistent decision-useful information for similar contracts.

Additionally, the standard’s application will provide substantial financial and business challenges and provide information that is neither useful nor sought after by general users of a contractor’s financial statements. Finally, the proposed accounting does not follow how contracts are managed from an operational standpoint, thereby increasing administrative costs.

The following example articulates the different views that construction financial professionals have provided in the application of the proposed separation principle – demonstrating the critical need to improve the guidance in applying the proposed principle to long-term contracts.

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**Facts:** In 2010, a calendar-year contractor enters into a two-year design-build contract with an owner to build 40 miles of commuter rail, including 12 bridges. The contract has the following additional characteristics:

- Assume December 31, 2010 year-end.
- The rail and bridges are customized to the owner’s specifications and owner changes to these specifications are permitted over the contract term.
- Nonrefundable, interim progress payments are required.
- The owner can cancel the contract at any time (with a termination penalty); any work in process is the property of the owner.
- Physical possession does not pass until completion of the contract.
- Total estimated contract revenue is \$400 million.
- Total estimated contract cost is \$300 million.
- Cost of the design work is \$5 million.
- Cost of each bridge is \$10 million.
- Cost of the commuter rail is \$175 million.
- Total year-one costs are \$180 million (\$5 million for design, \$60 million for six bridges, and \$115 million for the rail).
- Total year-one billings and collections are \$100 million.
- The construction company has determined, based on the totality of the above fact pattern, that control continuously transfers and that cost-to-cost is the most appropriate measurement metric.

Current revenue accounting: Under current guidance, the entity's results at the end of year one are:

JOB NUMBER	TOTAL ESTIMATED CONTRACTS				FROM INCEPTION TO 12/31/10					AT 12/31/10		PERCENT COMPLETE
	TOTAL ESTIMATED REVENUES	TOTAL ESTIMATED COSTS	ESTIMATED GROSS PROFIT	% PROFIT	REVENUE EARNED	COST OF REVENUES TO DATE	GROSS PROFIT	BILLED TO DATE	ESTIMATED COST TO COMPLETE	COSTS AND ESTIMATED EARNINGS IN EXCESS OF BILLINGS	BILLINGS IN EXCESS OF ESTIMATED EARNINGS	
	Design/Build	\$ 400,000,000	\$ 300,000,000	\$ 100,000,000	25.00%	\$ 240,000,000	\$ 180,000,000	\$ 60,000,000	\$ 100,000,000	\$ 120,000,000	\$ 140,000,000	

**Income Statement:**

Revenue	240,000,000
Costs of Revenue	<u>180,000,000</u>
Margin	60,000,000

**Balance Sheet:**

CIX	\$140,000,000
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As previously noted, the application of the proposed identification and separation principles remains unclear for long-term contracts and could lead to diversity in practice. Indeed, some may argue that there are only two performance obligations (design and build). Others may argue that there are three performance obligations (design, railway, and bridges), while others may argue that there are 14 performance obligations (design, railway, and each individual bridge).

Once a construction company determines its performance obligations, diversity will further continue in the assessment of how many performance obligations to separately account for. Companies that equally agree that there are three performance obligations (design, railway, bridges) may come to separate conclusions on how many of these performance obligations are distinct.

One construction company may believe that none are distinct on their own, while others may believe that each performance obligation is distinct. Accordingly, the following possible results could occur in applying the proposed model.

**View 1:** One construction company may interpret the guidance to suggest that there are only two performance obligations (design and build) and that each obligation is distinct. In this scenario, the construction company's results would be as follows:

Step 1: Allocate contract revenue of \$400 million

Estimated selling price – design	\$8 million (estimated)
Estimated selling price – build	\$420 million (estimated)
Relative allocation of revenue – design	\$7.5 million
Relative allocation of revenue – build	\$392.5 million

**Step 2: Recognize revenue on each separate performance obligation**

JOB NUMBER	TOTAL ESTIMATED CONTRACTS				FROM INCEPTION TO 12/31/10					AT 12/31/10		PERCENT COMPLETE
	TOTAL ESTIMATED REVENUES	TOTAL ESTIMATED COSTS	ESTIMATED GROSS PROFIT	% PROFIT	REVENUE EARNED	COST OF REVENUES TO DATE	GROSS PROFIT	BILLED TO DATE	ESTIMATED COST TO COMPLETE	CONTRACT ASSET	CONTRACT LIABILITY	
Design	\$ 7,500,000	\$ 5,000,000	\$ 2,500,000	33.33%	\$ 7,500,000	\$ 5,000,000	\$ 2,500,000		\$ -			100.00%
Build	\$ 392,500,000	\$ 295,000,000	\$ 97,500,000	24.84%	\$ 232,838,983	\$ 175,000,000	\$ 57,838,983		\$ 120,000,000			59.32%
	\$ 400,000,000	\$ 300,000,000	\$ 100,000,000		\$ 240,338,983	\$ 180,000,000	\$ 60,338,983	\$ 100,000,000	\$ 120,000,000	\$ 300,000,000	\$ 159,661,017	

**Income Statement – Current:**

Revenue	240,000,000
Costs of Revenue	<u>180,000,000</u>
Margin	60,000,000

**Balance Sheet – Current:**

CIX	\$140,000,000
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**Income Statement – Proposal:**

Revenue	240,338,983
Costs of Revenue	<u>180,000,000</u>
Margin	60,338,983

**Balance Sheet – Proposal:**

Net contract asset	\$140,338,983
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**View 2:** One construction company may interpret the guidance to suggest that there are three performance obligations (design, railway, and bridges) and that each obligation is distinct. In this scenario, the construction company's results would be as follows:

**Step 1: Allocate contract revenue of \$400 million**

Estimated selling price – design	\$8 million (estimated)
Estimated selling price – railway	\$300 million (estimated)
Estimated selling price – bridge	\$120 million (estimated)
Relative allocation of revenue – design	\$8 million
Relative allocation of revenue – railway	\$280 million
Relative allocation of revenue – bridge	\$112 million

**Step 2: Recognize revenue on each separate performance obligation**

JOB NUMBER	TOTAL ESTIMATED CONTRACTS				FROM INCEPTION TO 12/31/10					AT 12/31/10		PERCENT COMPLETE
	TOTAL ESTIMATED REVENUES	TOTAL ESTIMATED COSTS	ESTIMATED GROSS PROFIT	% PROFIT	REVENUE EARNED	COST OF REVENUES TO DATE	GROSS PROFIT	BILLED TO DATE	ESTIMATED COST TO COMPLETE	CONTRACT ASSET	CONTRACT LIABILITY	
Design	\$ 8,000,000	\$ 5,000,000	\$ 3,000,000	37.50%	\$ 8,000,000	\$ 5,000,000	\$ 3,000,000		\$ -			100.00%
Railway	\$ 280,000,000	\$ 175,000,000	\$ 105,000,000	37.50%	\$ 184,000,000	\$ 115,000,000	\$ 69,000,000		\$ 60,000,000			65.71%
Bridges	\$ 112,000,000	\$ 120,000,000	\$ (8,000,000)	-7.14%	\$ 56,000,000	\$ 60,000,000	\$ (4,000,000)		\$ 60,000,000			50.00%
	\$ 400,000,000	\$ 300,000,000	\$ 100,000,000		\$ 248,000,000	\$ 180,000,000	\$ 68,000,000	\$ 100,000,000	\$ 120,000,000	\$ 300,000,000	\$ 152,000,000	

**Income Statement – Current:**

Revenue	240,000,000
Costs of Revenue	<u>180,000,000</u>
Margin	60,000,000

**Income Statement – Proposal:**

Revenue	248,000,000
Costs of Revenue	180,000,000
Loss Provision	<u>4,000,000</u>
Margin	64,000,000

**Balance Sheet – Current:**

CIX	\$140,000,000
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**Balance Sheet – Proposal:**

Net contract asset	\$148,000,000
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**Note:** A \$4 million loss provision is recorded when the overall contract is profitable. This accounting is therefore inconsistent with the economics of the transaction.