



Liberty Mutual Surety

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Technical Director – File Reference No. 1820-100
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk CT 06856-5116

RE: Liberty Mutual Surety's Comments on Revenue Recognition in Contracts with Customers (File Reference No. 1820-100)

Liberty Mutual Surety appreciates the opportunity to offer our feedback on the joint FASB/IASB (Boards) Discussion Paper, Preliminary Views on Revenue Recognition in Contracts with Customers, (preliminary views document). We recognize the goal of FASB is to create one standard for which all industries will recognize revenue. Although this would be ideal, we hope FASB recognizes that within each industry there are unique transactions specific to the industry. Our commentary and observations are formed from the vantage point of being the user of financial statements in rendering what type of surety credit /capacity a contractor would qualify for based upon other criteria as well.

Liberty Mutual Surety is the branded surety underwriting and operating division of the Agency Markets business unit of Liberty Mutual Group. Licensed in all states, based on written premium, Liberty Mutual Surety is the 2nd largest writer of Surety in the United States. Liberty Mutual Surety operates with one of the higher U. S. Treasury underwriting limitations in the surety industry.

Liberty Mutual Surety provides a full range of global bond products for customers with small, middle and large market capacity needs. We specialize in providing contract surety bonds for construction firms, manufacturers and suppliers as well as commercial surety bonds for corporations and individuals. Surety operates primarily in the United States, its territories and in select international markets.

Liberty Mutual Surety provides unsecured surety credit on a single account basis in amounts exceeding \$500 million. The financial statement, in presentation and quality, is a critical part of the underwriting process. Our underwriting process includes gathering financial statement information on over 5,000 contract accounts. Our trending capabilities, including credit models and other typical surety ratio analysis, have been developed over years and are based on current accounting standards (SOP 81-1). They have stood the test of time to provide reliable information. Significant deviation from current standards will result in having to develop new models and until confidence is gained in these models the potential of reduced credit availability exists. We believe the proposed revenue recognition guidelines would result in inconsistent application of those standards and would put any user at a disadvantage vs. current guidelines.

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While we rely upon the financial statements as a starting point in the overall evaluation, we understand the internal issues/limitations of our construction accounts. These limitations include the ability to produce meaningful financials and accompanying schedules without the assistance of outside CPA firms who specialize in construction accounting. Sometimes the limitations extend to the CPA firms as well.

What seems to be the underlying issue in opening up our arms and embracing this is reliant more on the subjectivity as it relates to breaking up the contract in to performance obligations. Although it would help our underwriters when assessing how a contractor is performing if they knew how the contractor's current backlog breaks down; however, leaving the breaking up of performance obligations to each individual contractor will most likely decrease the ability to rely on comparing financial statements across the industry.

A construction contractor making improvements to others real estate, whether they are building a road, dam, rail road, bridge, building, waste water treatment plant, installing electrical systems etc, deals with a complex and dynamic environment. No single project is identical. Consistency of contract documents between various owners is only by chance.

The construction industry, from one contractor to another, is also diverse. Because a group of contractors perform general construction work, all possess differences in management of the company. The consistency across the industry and over a group of contractors is having statement presentation based on percentage of completion accounting with a single primary performance objective being the total project. The boards need to understand that the SOP 81-1 works and should include more of its language in the new proposed guidelines.

The overall objective of the proposed guideline is to “establish the principles that an entity shall apply to report useful information to users of its financial statements about the amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.” Rather than making revenue recognition consistent, using the completion of performance objectives as a measure, it will provide for significant disparity of information across the construction industry. Unless the accounting standard is written in greater specificity in determination of performance objectives, it is expected that each construction firm will approach this with significant differences. With the potential for diversity of project objectives, the process of obtaining an unqualified audit will become more time consuming and potentially more costly to the contractor. Unlike percentage of completion accounting, where the unit of measurement is consistent across all contractors and contracts, performance objectives will be different from contractor to contractor and although with the same contractor, performance objectives from one construction contract to another may differ and will be subject to much debate by the various users, thereby getting away from the overall objective of the proposed guidelines. Management has the ability to expedite the revenue recognition process at their sole discretion if this standard is approved as proposed without additional or clarifying language.

If the guidance was more specific as to what a contractor can and cannot breakout as separate performance obligations, and what method of recognition is allowed for types of contracts, it's possible the change would not be as unwelcomed as it seems to be currently. The current exposure draft is written broadly with an unintended consequence of the potential for greater incidence of Financial Statement Fraud. Introducing broad rules after having very specific rules as it relates to construction contractors revenue recognition could open the flood gates of creative financial statements in the years following adoption of the exposure draft.

It is recommended that the establishment of Performance objectives be defined using a more rigid test similar to or the same as the “Segmenting a Contract” currently written in SOP81-1.

We are please to respond to the questions posed as follows:

Question 1.

In construction contracting there are few if any reasons to either combine or segment contracts. Many contracts, specifically those with various governmental units, including the federal government, are subject to audit. It is necessary that although projects could be bid simultaneously that all cost records are kept separate. It would then

follow that all revenue should also be kept separate. Although the contractor may chose to gain some efficiency in performing the contracts, such as using the same project management team, these are operational decisions and not made for revenue decisions. The underlying contract and the expectations of the customer should prevail.

Change orders, by definition, are priced independent of the contract but by contract terms and conditions are made a part of the total contract. The change order becomes a part of the primary performance objective of successful completion and delivery of the product being built at the price and specifications to the owner. The profit in the change order becomes a part of the pool of profit in the total project. Whether it will be fully earned is subject to the successful completion of the total job within the construction estimate. Therefore all contract modification should not be treated as a separate contract.

Question 2.

The proposed model to identify a performance obligation in a contract:

- Account for a component of the contract separately if it is distinct:
 - It is sold separately
 - It could be sold separately because
 - It has a distinct function
 - It has a distinct profit margin

This is contrary to the owner of the work in progress expectations of the contract. When a construction contractor estimates a project all parts of the project are given a cost. At that time, the contractor may elect to place a profit on a specific work item or after developing the costs place a profit, overhead and contingency on the total. Although it could be argued that performing the site work, installing footings and foundations etc are distinct functions and may carry distinct profit margins, the decision to sell these items separately would belong to the owner of the work in progress, who has already elected to bundle those activities into a single contract. It can also be argued that if the construction contractor should chose to subcontract a scope of work, this work could be viewed as a distinct function and could have a distinct profit margin. However, it is not separate because the contractor is still charged to perform the project management and supervision of the contract. The activity of project management to deliver to the owner a complete building ties all the activities together into a single performance objective.

Establishing a profit/loss on each performance objective can lead to misinformation. If a contractor places most of the profit on the first performance objective to be completed, the statement may not reflect the construction risk completed or yet to be completed. In this case the contractor, using the performance objective measure for earned revenue, will earn most of the profit on the job early in construction, yet there is significant construction risk remaining. Under current accounting standards, this aggressive assignment of profit would be resolved by recognition of an overbilling.

In some regard, the use of performance objectives and potential risk of earning profits too soon, is akin to having the revenue earned per the schedule of values presented by the contractor to the owner. The schedule of values is used to give the owner some indication of the cash flow requirement needs to pay the contractor as the job progresses. A contractor will “front load” the schedule of values to some degree to gain cash position from the project to assist in financing the work. Owners or customers realize that “front loading” takes place and as long as it is reasonable do accept and expect it. Since payment by the owner does not reflect acceptance of work, they are comfortable allowing some “front loading.”

Establishing performance objectives and assigning a profit to each can develop misleading information. In a construction contract, there is only one prime objective and that is to present the owner with a complete contract at the specifications and costs as established by the terms and conditions of said contract. There is only one pool of profit dollars that a contractor can earn. Management of a construction company is concerned with the various activities on a construction site and provides the project management to successfully complete a contract. Cost accounting systems are in place to financially track the progress of the job by these activities. However, contractors also know that any budgeted profit dollars made on any one segment of a project is subject to any profit fade on the remainder of the job.

Measuring revenue by performance objectives and the payments made toward the completion of the objective may not reflect the intent of the contract. Many of these arguments were vetted when SOP81-1 was written. Because of the uncertainty of consistent in developing measurable and consistent performance objectives, using percentage of completion based on measurable items of cost, labor hours, units delivered etc was instituted. Where construction **work is to improve real estate for others**, percentage of completion accounting would seem to continue to better reflect the contract terms and conditions and provide a revenue dollar that is reflective of the construction risk completed.

Question 3.

In all construction contracts, there are provisions for interim payments. Normally, unless there are specific benchmarks dictated by the contract, the construction contractor will present an invoice on a 30 day schedule. However, also within the same contract, there is specific language that payment to the contractor does not imply the owner is accepting the work. The owner or customer accepts the contract when the job is completed.

Construction contracting is done on other's property. The contract to build is an agreement between parties allowing the contractor to enter the property and build or improve an asset for the owner. As the terms and conditions of the general contract flow through to the subcontractors, this also holds true for them. The contractor has never had ownership to the construction. While they build, the contractor is developing a lien right that may protect them if they are not paid, but they are not directly developing an ownership position in the property. In that regard, the acceptance and final payment by the owner is not an exchange of ownership but an agreement that the contract has been satisfactorily completed.

Some contracts call for the owner to take occupation of parts of the building before construction is completed. This is done to facilitate the business of the owner and an agreement between parties of the possible interference in construction. The owner is not accepting the work because they are taking possession.

When the owner and contractor agree the contract is satisfactorily completed, the singular performance obligation of the contract has been met.

Question 4

We agree with the caveat that the performance obligation of construction contracting is singular. In construction contracting the total concept of developing a contract value is dependent upon reasonable estimates based on current and historical cost data and experience. One would anticipate that if any of those items noted in paragraph 39 were excessive, that the construction contractor would chose not to bid the project.

Question 5

We do not agree. In construction contracting, if a contractor feels there is a credit risk, they will either chose not to bid the job, or increase their price to reflect the additional credit risk. Should a credit risk occur and non-payment or reduced payment is experienced, the difference should be handled as a bad debt expense or in the bad debt allowance and not a reduction in construction revenue. Revenue for a construction contractor should reflect the revenue produced via the construction operation and not be prejudiced by a business risk.

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Question 7

We do not agree. See reply to Question 2.

Question 9

We agree, but take this opportunity to comment on paragraph 63.

The onerous test would seem appropriate however; it does assume that a construction project has numerous performance obligations. From an operational management viewpoint, the contractor's management will want to know if they are making or losing money on specific construction activities. But, from a financial management viewpoint, they also know that there is only one pool of profit to be earned. That profit is the difference between the total contract costs and the total dollars agreed to with the owner. Until the job is completed and delivered, all profit on the project and if the project loss is a portion of the company's capital is at risk. At risk of repeating, a construction contractor who perform work to improve others real estate has one performance objective.

Question 10

We agree

Question 11

We disagree. A fuller disclosure including total obligations remaining, amount of obligation that exceed one year and two years or more, future profit potential for all, one year and two or more and remaining cash flow

Question 12

We agree

Question 13

No, this will be a huge undertaking on a prospective basis, let alone a retrospective basis. The effort to accomplish this would far outweigh any potential benefit as contractor personnel would be purely guessing at this point. To restructure what is "performance obligation," and "onerous costs" would put an undue burden on everyone involved in the process of generating a financial statement and would provide absolutely no benefit to the users, in our case, the surety.

Question 14

Example 11 provides us with the confusion and lack of clarity that will lead to much subjectivity in what determines separate performance obligations. Based upon the definition described in IG63-66, the "continuously delivering the services" clause necessary to account for transaction within the percent complete framework is not met and therefore, we have completed contract accounting which would set back financial reporting for construction contractors 30 years.

Question 15

We agree with the definitions as provided, however unless there is a specific pay item in the construction contract, the contingent liability for possible warranty work should not be accrued on the balance sheet. This may result in the job, having been completed some time ago to remain open. We suggest that warranty be treated as a contingent liability and disclosed by footnote.

Question 16

Not applicable to construction accounting

Question 17

No comment

Question 18

The revenue recognition guideline in the construction industry should apply to public and private firms alike. If the decision is to adopt for publicly traded firms, it should provide as an alternate, reporting under SOP 81-1.

Additional comments:

The proposed model to identify the contract has little change from that currently in place. For construction contracts, the contract documents provided by the owner of the work in progress should prevail on how any segment is treated. The same thought process can be used when dealing with change orders.

Because of the challenges of an unpriced change order, they should be handled on a most conservative method. Numerous change orders of this nature result in long term negotiations, and many times result in a construction claim. A preferred method would be to only accept cost and delay the acceptance of profit recognition pending a signed and priced change order.

Unless there is a rigid test to recognize performance incentives prior to when fully earned, incentives should not be included in the transaction price. As the terms of the contract provides for an incentive when a certain benchmark is completed, the underlying provision of the incentive must be met before it is fully earned and collectable. The owner of the work has no intent of paying the incentive until the benchmark is met, therefore recognizing a part of the incentive before it is fully earned without rigid testing is problematic. The draft allows recognition on a probability of collectability, thus increasing the amount of the performance obligation dependant upon a calculation of the probability of collection. Although the incentive amount recognized will not be the full amount allowed until actually collected (unless the probability of collection is 100% certain), the contractor will increase the value of their work on hand based on a probability factor that is not 100% certain. This allows for the recognition of more revenue and profit in the beginning accounting cycles of a long term contract that may in subsequent years have to be written down.

The proposed model for uninstalled materials does reflect the terms and conditions of the contract. However, recognizing revenue and profit on the materials is not an appropriate measure of construction risk completed. The risk in construction is not in the procurement of materials but is in the installation of those materials. If revenue is recognized it should be at zero profit or very little profit. There is little risk in identifying the material and placing a purchase order. Any profit accepted on the material is subject to any profit fade experienced as the contractor completes the contract.

The disclosure of contract durations is seen as an unopposed addition to the financial statements. This is one less question the underwriters would have to ask of the contractor when reviewing their work on hand. Additionally as noted above seeing a contractor break out performance obligations that show a loss before the project starts might

attract additional attention to their backlog. Especially for those contractors with low profit margins as it is. The separate pricing of change orders is only to the extent that it can be discretely priced, which could possibly help contractors to track how major change orders are affecting their bottom line. For those change orders that can not be discretely priced it is our understanding that they are included as an increase in transaction value of the performance obligation.

The following is an example of what may happen if a contractor were to adopt the proposed standard as written. We typically ask a contractor to submit their work in progress schedule along with their reviewed or audited financial statements. Our example is of the effect the proposed standard would have on the work in progress schedule. The scenario is the contractor was awarded a contract to build a big box building for \$10,000,000 that included site preparation and paving and landscaping estimated to cost \$9,000,000. Assuming that at the end of year one the contractor had completed \$4,000,000.

Using current standards, the financial disclosure on the work in progress schedule would be as follows:

Description <i>1</i>	Total Contract <i>2</i>	Costs			Gross Profit <i>6</i>	Gross Profit % <i>7</i>	Pct Comp <i>8</i>
		To Date <i>3</i>	To Complete <i>4</i>	Total <i>5</i>			
Big Box Building	10,000,000	4,000,000	5,000,000	9,000,000	1,000,000	10.00%	44.44%

Revenue % Comp <i>9</i>	Progress Billings to Date <i>10</i>	Costs and Estimated Earnings in Excess of Billings <i>11</i>	Billings in Excess of Costs and Estimated Earnings <i>12</i>	Gross Profit Recognized To Date <i>13</i>
4,444,444	4,200,000	244,444	-	444,444

Using the same information, if the contractor were to use the output method of revenue recognition the financial disclosure on the work on hand would be as follows:

Performance Obligation <i>1</i>	Total Contract <i>2</i>	Costs			Outputs (Var. Units of Measure)		
		To Date <i>3</i>	To Complete <i>4</i>	Total <i>5</i>	Work In Place <i>6</i>	Work to Place <i>7</i>	Total Outputs <i>8</i>
Site Preperation (Acres)	3,200,000	2,700,000	800,000	3,500,000	9	1	10
Building Construction (Sq Ft)	4,800,000	1,300,000	2,400,000	3,700,000	15,000	25,000	40,000
Paving (Cubic yds)	1,100,000	-	800,000	800,000	-	10,000	10,000
Landscaping (Acres)	900,000	-	1,000,000	1,000,000	-	7	7
	10,000,000	4,000,000	5,000,000	9,000,000			

Performance Obligation	Gross Profit	Gross Profit %	O/P Pct Comp	Revenue % Outputs Comp	Loss Liability	Progress Billings to Date	Const. Asset	Const. Liability	Gross Profit Recognized To Date
1	9	10	11	12	13	14	15	16	17
Site Preparation (Acres)	(300,000)	-9.38%	90.00%	2,880,000	(300,000)	2,200,000	680,000	-	(120,000)
Building Construction (Sq Ft)	1,100,000	22.92%	37.50%	1,800,000	-	2,000,000	-	200,000	500,000
Paving (Cubic yds)	300,000	27.27%	0.00%	-	-	-	-	-	-
Landscaping (Acres)	(100,000)	-11.11%	0.00%	-	(100,000)	-	-	-	(100,000)
	<u>1,000,000</u>	<u>10.00%</u>		<u>4,680,000</u>	<u>(400,000)</u>	<u>4,200,000</u>	<u>680,000</u>	<u>200,000</u>	<u>280,000</u>

The revenue recognized is \$235,556 greater in this approach than in the cost to complete used in the previous example. Conversely the gross profit is \$164,444 less than in the cost to complete in the previous example. This is due to the requirement to recognize the loss (onerous performance obligation) expected on both the site preparation and landscaping portion of the overall contract. Additionally the construction asset and construction liability that is created causes the confusion with respect to what was previously viewed as costs and estimated earnings in excess of billing and billings in excess of costs and estimated earnings. This information helps to identify if a contractor is “borrowing” from their work in progress (significant overbillings), or if a contractor is avoiding profit fade and losses (significant underbillings).

One final example with the same scenario, but using the input method of revenue recognition is as follows:

Performance Obligation	Total Contract	Costs			Gross Profit	Gross Profit %	Pct Comp
		To Date	To Complete	Total			
1	2	3	4	5	6	7	8
Site Preparation (Acres)	3,200,000	2,700,000	800,000	3,500,000	(300,000)	-9.38%	77.14%
Building Construction (Sq Ft)	4,800,000	1,300,000	2,400,000	3,700,000	1,100,000	22.92%	35.14%
Paving (Cubic yds)	1,100,000	-	800,000	800,000	300,000	27.27%	0.00%
Landscaping (Acres)	900,000	-	1,000,000	1,000,000	(100,000)	-11.11%	0.00%
	<u>10,000,000</u>	<u>4,000,000</u>	<u>5,000,000</u>	<u>9,000,000</u>	<u>1,000,000</u>	<u>10.00%</u>	<u>44.44%</u>

Performance Obligation	Revenue % Inputs Comp	Loss Liability	Progress Billings to Date	Const. Asset	Const. Liability	Gross Profit Recognized To Date
1	9	10	11	12	13	14
Site Preparation (Acres)	2,468,571	(300,000)	2,200,000	268,571	-	(531,429)
Building Construction (Sq Ft)	1,686,486	-	2,000,000	-	313,514	386,486
Paving (Cubic yds)	-	-	-	-	-	-
Landscaping (Acres)	-	(100,000)	-	-	-	(100,000)
	<u>4,155,058</u>	<u>(400,000)</u>	<u>4,200,000</u>	<u>268,571</u>	<u>313,514</u>	<u>(244,942)</u>

In this example the contractor is recognizing reduced revenue and also they will show a net loss before any general and administrative expenses. If we are to rely on this information, potentially the contractor’s ability to maintain their current surety credit could be affected.

These examples were simplified to a certain extent, but highlight some of the pitfalls of the current proposal as written. We would like to see the FASB state in their new proposal that those businesses that are within the

construction industry **where the end result of the work is to improve real estate for others** should follow a more specific approach in recognizing revenue. The approach should not allow for the contractor to determine if there are parts of their contracts that could be done separately, but that each construction contract is by its nature a separate performance obligation. We would also like to see language that notes the input method is the better more conservative approach. This would remove preference to the output method for construction contracts, due in larger part that the some of the subjectivity that is inherent in the current proposed guideline.

Thank you again for allowing us to respond on what is potentially one of the biggest changes to the construction industry since the issuance of SOP 81-1.

Sincerely,

James D Gersch, AFSB

