

# KATZ, SAPPER & MILLER

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Technical Director  
File Reference No. 1820-100  
FASB  
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Dear Sir or Madam,

We appreciate the opportunity to comment on the Revenue Recognition (Topic 605) *Revenue from Contracts with Customers* exposure draft.

Katz, Sapper and Miller, LLP is a large public accounting firm serving hundreds of middle-market clients, many of whom are in the construction industry. We provide audit and review services for construction clients, who range in size from \$1,000,000 to \$350,000,000 in revenues, as well as compilation services for our smaller clients. In general, we are concerned that the added costs and complexity required to comply with this exposure draft are unnecessary to reach the goal of consistent and accurate financial reporting for contracts, particularly in the construction industry. We believe the proposed rules will actually increase the subjectivity and inconsistency in accounting for construction contracts

## **Limited Benefits**

The construction industry is comprised of predominantly small, owner managed, closely held enterprises. They operate on slim profit margins and utilize lean, but efficient accounting departments. As we work with our clients, we strive to help them establish proper accounting and reporting mechanisms that complement their operating and measurement techniques. The proposed rules will require redundant accounting systems, one for financial reporting, and another for internal operating purposes. In addition, the proposed rules will greatly increase the differences between financial and tax reporting. We need convergence of management reporting and financial reporting, this proposal is a step backward.

More specifically, the added complexities of separating and accounting for contracts by performance obligations will overwhelm our clients' human capital and information systems. Allocating revenues to the performance obligations will be extremely subjective, and auditing those revenue allocations will prove costly. Contractors generally bundle their services and provide one price, subcomponents are not sold, nor priced; therefore, allocations of revenue to performance obligations will be based on internal projections, not independently verifiable evidence.

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## Goals Not Met

While the reasoning for the proposed guidance, to provide better information to users is noble, the theories are not sound in relation to the realities of the construction industry. We believe that the following goals will not be achieved:

- Remove inconsistencies:

The surety industry provides billions of dollars of financial backing to the construction industry. As we interact with users of the financial statements, including sureties, bankers, project owners, vendors, state regulators and the company's owners, we find a high degree of consistency between contractors' financial reporting. The most common complaint from third party users of contractors' financial statements arises when a contractor employs an auditor or CPA unfamiliar with the unique aspects of the construction industry and SOP 81-1.

These financial statement users often identify the following inconsistencies in financial reporting between construction companies today:

- Conservative or aggressive nature of the individual contractor when estimating job performance and job profitability
- Allocation of expenses between job costs or general and administrative costs
- Accounting for emerging project delivery methods such as construction management, design build, unit price contracts, etc.
- Accounting for change orders and claims

The above inconsistencies indicate a need to update and clarify the current guidance contained in SOP 81-1. However, the complete overhaul of revenue recognition as contained in the exposure draft will add inconsistency, not promote consistency, as follows:

- Inconsistencies will be more prevalent by the introduction of additional interpretation and estimation from this exposure draft.
  - It is not likely that all entities would separate a contract into the same performance obligations.
  - It is improbable that all entities would allocate the transaction price in similar proportions to the performance obligations, which already may not be the same as determined by another entity.

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The subjectivity in determining and pricing performance obligations will provide opportunities for the contractor to manipulate profits as a project is performed.

### **Lack of Alignment with Practices**

Contractors predominantly sell construction services as one unit (contract), or one performance obligation. In practice, construction jobs are estimated and managed by phases. These phases are often delineated by critical path scheduling or time requirements, type of work, mix of labor and materials, and risk. Despite the concept of these individual phases, contracts are awarded on one price. To obtain objective pricing of these phases is inherently difficult. Contractors do not supply their competitors with accurate pricing.

The methodology of valuing performance obligations, and therefore recognizing revenue, under this Proposal would, in most cases, require the use of Level 3 inputs (which are defined as significant, unobservable inputs under the framework set by FASB within ASC 820), as “market prices” for separate performance obligations are often not observable. ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*), displays a clear bias against Level 3 measurements.

Pricing of performance obligations will be developed internally, which is hardly objective. Auditors will be challenged to verify both the accuracy and consistency for determining performance obligations and pricing of these performance obligations

In addition to added costs and complexity, contractors simply do not measure revenue by these performance obligations. Upon reflecting on successful or unsuccessful projects, a construction executive will report “that job went well for us,” not “we really did well on all of our performance obligations.” The bottom line is that contractors bid, manage and measure construction projects as one project consuming costs and providing revenue over a certain period of time.

### **Summary**

We concur that financial reporting of revenues from construction contracts should be improved and consistently applied. However, accounting for a construction contract as predominantly anything other than one performance obligation, delivered over time, measured by costs incurred is inherently incorrect. Bifurcating contracts into separate revenue units and pricing those units will add complexity and inconsistency among construction companies and provide an opportunity to manipulate financial results.

We recommend SOP 81-1 be updated for guidance on the following matters:

- Accounting for evolving construction delivery models and project financing changes
- Allocation of costs to general and administrative or job costs
- Accounting for change orders and claims

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We appreciate the opportunity to provide our comments.

Sincerely,



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