March 5, 2012

Ms. Leslie Seidman Chairman Financial Accounting Standards Board 401 Merritt 7 Norwalk, CT 06856

Re: Proposed Accounting Standards Update, Revenue from Contracts with Customers ("Proposed ASU") (File Reference No. 2011-230)

Dear Ms. Seidman:

As you know, I am a member of the Private Company Financial Reporting Committee (PCFRC), as well as representing the interests of the construction industry through the efforts of the Construction Financial Management Association (CFMA), both of which will provide their response to the Proposed Accounting Standards Update on Revenue from Contracts with Customers. I am also submitting my own response to the proposed ASU. Some of my views may differ on certain points compared to the financial statement preparers, or public CPA's, specifically. While the users of financial statements (i.e., banks and surety companies) tend to agree with my positions, they may not be as vocal in stating their opinions as someone like me who is, and has been, in the construction industry for over twenty-three years.

Rather than responding specifically to the Respondent Questions, I believe that my input is more relevant to several specific issues not covered by the questions.

## Input Methods – Accounting for wasted materials, labor or other resources

Paragraph 45 of the Proposed ASU indicates that, when using input methods, "...an entity shall exclude the effects of any inputs that do not depict the transfer of control of goods or services to the customer..." Also, paragraph 93 of the Proposed ASU, and specifically sub-paragraph (b), requires entities to expense the "Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract." Although not clear, the assumption would be that these costs should be period costs (or overhead), rather than being capitalized (or included in Work In Progress on the balance sheet).

There are several flaws in the logic behind this proposed practice, particularly as it relates to the construction industry. First, is the assumption that **all** costs are known in advance of performing on a contract (performance obligation, under the Proposed ASU). In actuality, construction bids are estimates of costs to build a particular project. When there are variances, over or under, in the actual costs to perform on the contract versus the project estimates, these variances may be the result of a poor estimate, or inefficient use of labor, materials or subcontracted efforts, or unexpected site conditions, inclement weather, etc. (unexpected conditions often result in change orders to the contract).

Second, standard practice in the construction industry is that total estimated costs, the project budget or the schedule of values as it is referred to in the industry, are periodically (usually monthly) assessed to determine if the project can be completed for what remains in the budget. This is a line-by-line, detailed assessment of estimated costs to complete a project, and includes assessments of both projected cost overruns and projected savings for any line item of the budget. Conservative practice dictates that cost overruns are recognized as soon as they are known, while cost savings are not typically recognized until the contractor is reasonably certain that they will be realized. In this way, I believe, the impact of "...wasted materials, labor, or other resources..." is already being taken into account in the reporting of revenue on construction projects.

Third, I believe it is important to keep **all** costs related to the performance on a contract in the job costs, rather than making some judgment on what portion of costs might be costed instead to overhead. Construction contractors routinely use the actual costs on one project to help them to estimate more accurately the costs of similar projects. The ability to do so is eroded, if financial pronouncements require cost overruns to be moved to period cost, rather than staying with the project to which they relate. The argument to keep all costs on the project is an argument for sound business practices that provide management a basis for assessing mistakes so that they are not repeated on future projects.

Assuming that paragraph 45 relates specifically to construction, it is my recommendation that the paragraph be stricken in its entirety from the pronouncement. If the paragraph has relevance to other industries, then I suggest that added clarifications to that end are needed.

## Input Methods – Accounting for goods for which the customer obtains control significantly before receiving services related to those goods

Paragraph 46of the Proposed ASU, as it relates to construction, suggests that, when significant materials have been delivered to a job site but have not yet been installed, "...the best depiction of the entity's performance may be for the entity to recognize revenue for the transferred goods in an amount equal to the costs of those goods..." In other words, the contractor would recognize no gross margin on these costs.

I would also like to respectfully point out several flaws that I believe are inherent in this logic. First is the assumption that a different weight should be given to costs related to materials versus labor; or that somehow labor required more effort, or had more value, than materials. Especially in today's global economy, where granite for a project may come from China or Brazil, marble from Italy, or significant heating, cooling or specialized equipment from Germany or Japan, the efforts expended in locating the required materials, arranging for international payments, and scheduling deliveries to facilitate construction schedules are often significant. In addition, when the project is estimated the contractor does not give a different weighting to materials, labor or subcontracts. On bid day all estimated costs are calculated and, in the final moments before the bid is submitted, a determination is made as to what percentage of profit will be added to total costs to arrive at the total contract price. When estimated costs to complete the project are reviewed there is no weighting of whether a cost is labor or materials; all costs are considered equally.

Second, it is my contention that common practice in the industry, as well as the intent of the contracting parties, should be considered. It is common practice in the construction industry that periodic (Usually monthly) pay requests are submitted to the project owner for payment. The owner's representative reviews the pay request and generally walks the site to see the progress on the job before approving the

pay request for payment. This process is usually also prescribed in the contract. If it is the intent of the parties for the owner to review progress, accept work performed to date (which often includes materials on site, but not yet installed) and to pay for this work based on the pay request, then revenue should be recognized to the extent of the accepted billing. Now, I understand that it is more complicated than that, since there will be a calculation of either Costs in Excess of Billings or Billings in Excess of Costs, but that calculation is based on costs expended to date as compared to total estimated costs – without any weighting of costs related to either labor or materials.

Third, there is the legal aspect of who would "own" the materials if the contractor were to default and fail to continue performance on the project. In recent PCFRC committee meetings an example was used of a bridge builder who may have delivered all of the steel for a bridge to the job site and then defaulted on future performance, or the installation of the steel, specifically. First, I would point out that it is not likely that a contractor would deliver such a significant component of project expense to the jobsite without an expectation of being paid for the effort; but I understand that we are not just looking at the contractor side of the event. In a lawsuit brought related to damages for default on the contract the owner would likely sue for the costs of replacing the contractor who defaulted on the performance, as well as for damages related to time and schedule delays, lost profits, etc. The steel delivered to the site would, in all likelihood, not be mentioned in the lawsuit since the owner has possession of those materials. There could potentially be a counter-suit from the contractor, if the owner had not paid for the steel. I would also point out that we are not talking about raw steel, but are referring to steel which has been cast, cut, welded and otherwise worked to meet very specific design specifications. The steel delivered to the jobsite is, for the most part, not suitable for building any other project without significant rework. It was designed for this specific bridge. The same is true for most other significant materials on any given construction project.

In the Summary and Questions for Respondents section of the Proposed ASU guidance on when to recognize revenue states that, "A good or service is transferred when (or as) the customer obtains control of that good or service." Speaking further about satisfying a performance obligation over time the ASU also provides that an entity, "...recognizes revenue over time if at least one of the following two criteria is met:

- 1. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced.
- 2. The entity's performance does not create an asset with an alternative use to the entity and at least one of the following criteria is met:
  - b. Another entity would not need to substantially reperform the work the entity has completed to date if that other entity were to fulfill the remaining obligation to the customer."

(Note that I have not quoted either 2(a) or 2(c), since the requirement is that only one of the three criteria be met)

It is my contention that both of the requirements above are satisfied with the delivery of significant materials to jobsite, which have not yet been installed. For Criterion #1 this is based on an interpretation of the words "creates or enhances." I believe that the intent of these words is satisfied through "...the efforts expended in locating the required materials, arranging for international payments, and scheduling deliveries to facilitate construction schedules...(see the first paragraph of this section of my response)" and the fact that the customer now controls the assets, or the materials, delivered to the jobsite. Criterion #2 is also satisfied, since the material delivered to the jobsite does not have an alternative use without significant rework, and a successor contractor would also not need to "reperform" the efforts required to get the materials to the jobsite.

Again, assuming that paragraph 46 relates specifically to construction, it is my recommendation that the paragraph be stricken in its entirety from the pronouncement. If the paragraph has relevance to other industries, then I suggest that added clarifications to that end are needed.

I hope that I have expressed my thoughts clearly. However, if there are questions or needed clarifications, I may be reached at (915) 877-3333. I appreciate the FASB's objective consideration of my comments and recommendations.

Sincerely,

Steven D. Lords, CPA, CCIFP Chief Financial Officer CF Jordan Construction, LLC