Revenue Recognition in contracts with customers – IASB Exposure Draft, June 2010

Comments by FIEC

FIEC is the European Construction Industry Federation, representing via its 34 national Member Federations in 29 countries (27 EU & EFTA, Croatia and Turkey) construction enterprises of all sizes, i.e. small and medium-sized enterprises as well as "global players", carrying out all forms of building and civil engineering activities.

For a number of construction projects where a continuous transfer of control to the customer occurs while works progress, the accounting of construction contracts, as proposed in the IASB Exposure Draft of June 2010, provides a representation which is consistent with the existing principles of IAS 11 and 18, and IFRIC 12 and 15.

This is important, because for most construction companies, the IAS 11 is a well functioning standard. It has a long application record based on well-known practical concepts. It is well established among the various parties of the construction process, including financial parties such as banks, investors, analysts and owners. For these reasons, a majority of construction companies would recommend maintaining IAS 11 as a distinct standard. However, if the IASB does not take construction contracts out of the scope of the new Revenue Recognition standard, then important amendments would need to be made to the new standard in order to better translate the economic substance of construction contracts (see the list of comments here below).

FIEC's main concern regarding the IASB Exposure Draft is that the new model requests splitting the contract into separate performance obligations in every contract with customers. For those companies which manage contracts by considering different risks depending on different performance obligation, such a recognition criterion is relevant. But when the contract is specific, managed and negotiated with a single client as a whole, the necessity to unbundle the contract by artificial performance obligations on a non-contractual "subjective" basis would not be relevant.

For this reason, FIEC recommends that the final standard be adapted to companies' business practices/model as key indicator to decide on the revenue recognition model.

1. **Combining, segmenting and identifying separate performance obligations:**

   1.a. Opinion of a majority of FIEC contributors to this issue[1]:

   The proposed segmentation of an overall project into several virtual partial contracts distorts the representation of the actual situation and may lead to a succession of profits or losses over the life-time of the project which is mistakable and misleading.

   This is especially true as the criterion to establish prices' independence or interdependence focuses on the fact that partial performance of complex construction projects are or might be offered by third parties, without considering the overall project and functional context appropriately.

   Moreover, the two-level segmentation system proposed in the ED – first, criterion of price; second, criterion of performance obligation – is much too complex to implement and does not correspond to the way construction contracts are internally managed by most construction companies.

   Combining and segmenting a contract are concepts already dealt with in IAS 11. In particular the ED's condition of paragraph 13.a),b),c) for combining are similar to those evidenced by IAS 11.9 but they appear different for segmenting. In order to allow a proper interpretation of the standard it would be appropriate to confirm IAS 11's conditions that explain exhaustively the matter of combining and segmenting a contract.

   1.b. Alternative opinion of a minority of FIEC contributors to this issue[2]:

   The proposed model improves the quality of financial reporting for those construction contracts where the contract is managed taking into account different risks for each different performance obligation. In those cases where it is practicable, recognizing revenue based on performance obligations will mean a more useful and reliable financial information. Although in those cases where it is impracticable to identify different performance obligations it should be allowed to recognize revenue based on input methods and consider the entire contract as a single performance obligation.

2. **Contract modification:**

   An additional matter is represented by "contract modification" because IAS 11.13,14,15 set out the accounting for three frequent cases of contract modification for construction industry, while the ED does not deal specifically with those cases. It appears that these revenue components could represent "contract modifications" but such conclusion is not well defined by the ED itself. If they represent contract modification the consequent revenue recognition is subject to paragraph 10 of the ED. In this case there could be frequent situation whereby the revenue recognition is postponed with respect to the costs incurred because the work started without the approval of the "contract modification". IAS 11 allow the recognition if it is probable that the customer will approve the modification. In order to avoid misunderstanding with users is would be advisable to maintain the probabilistic concept for recognize revenue as well as the expected value's concept for measuring revenue. Finally it is important to consider that for a number of companies a contract modification (the three cases of IAS 11.13,14,15) in construction industry is not a separate contract but a natural element of the original contract, therefore on this respect it could be useful if the application guidance of the new IFRS should cover specific industry topic like "variations in contract work, claims and incentive payments) as is in the IAS 11 paragraph 11-15.

[1] In the present case: 4 of FIEC members.
[2] In the present case: 1 of FIEC members.

3. **Continuous transfer of control – criteria:**

   In order to avoid that the recognition of revenue happens too late, from an economic point of view, for certain project constellations, the requirements concerning the transfer of control to the customer in the case of a continuous transfer along the construction process need some clarification. This concerns in particular the "customer acceptance" as a requirement for transfer of control to the customer.

   Moreover, the DP previously mentioned the "construction on the client's property" as indicator of continuous transfer. This criterion is important for construction companies in the sense that it clearly indicates that buildings built on the client's property are not owned by the construction company - who cannot take back the building and sale it to a third party - and the client has control on the building being built on his property. This indicator should therefore be reintegrated amongst the other indicators of continuous transfer.

   Also, it is not clear if the ED provides solutions for subcontracting issues, that is, for contracts on subcontracted tasks between two contractors. In this case, the task would not be performed on the customer's property, but rather on a third-party's property from the subcontractor's point of view... Meanwhile, the IAS 11 currently provides applicable solutions for such cases.

   Otherwise, among the indicators of control listed in paragraph 30, the only one suitable for construction contracts, is the one defined in paragraph 30.d "customer-specific". As a matter of fact unconditional obligation to pay, legal title, physical possession, are not applicable for construction industry as in many cases they occur just at the very end of work completion even if the contract usually provides, for example, progress payments. The indicator "customer-specific" represents the ability to direct the use of, and receive the benefit from Work In Progress (WIP) because every WIP is subject to the power (ability to direct use) of the customer to customize it for its own purposes. The new accounting standard could be improved for construction industry by introducing a precise reference to the meaning of WIP's control suggesting that this reference should consider the indicator "customer-specific".

4. **Contingent losses for separate performance obligations ("Onerous Performance Obligations"):**

   It is misleading to recognise contingent losses for separate virtual partial contracts and/or performance obligations in the financial statements, while the overall contract is profitable.

   Firstly, for those construction companies which usually determine the contract price according to the overall costs and the global margin (see 1.a), it would not give a coherent representation of the company's performance to calculate losses because of intermediary performance obligations with a negative margin, while the overall contract is profitable. Risks and margins are mutualised in order to be profitable at a global level.

   Secondly, as the first segmentation level is based on the interdependence of prices, it would not be coherent to calculate contingent losses for performance obligations whose prices are interdependent.

   Finally, a number of companies manage each contract as a single unit producing costs and revenues and the performance of the contract is evaluated, even for management reporting, considering the overall contract and not the single step already performed. Therefore the driver defined in paragraph 23.a is difficult to apply and meaningless in terms of contract measurement and presentation if, for example, an entity's business is the production of a good/service which comprise just one component (such as design) and another entity's is the production of a good/service composed by two items (such as design &construction). The latter situation, according to paragraph 23.a, shows two performance obligations, while according to the customer/entity relationship the intention of both parties is to design and build a unique, complex infrastructure; therefore they consider the contract as a single performance obligation. The principle set out in paragraph 23 could be improved, reducing complexity in the application and complying with the objective of uniform accounting by eliminating the reference to "another entity" which is foreseen on 23.a and 23.a.i. There is no informative value of separating a contract into several performance obligations due to the complexity of the construction contract, while the only concept which will be valuable for prepares and readers is the appropriate approach to combining and segmenting.

5. **<u>Costs recognised as expenses – ED paragraph 59:</u>**
   Costs incurred for obtaining a contract **should not** be treated as expenses. Instead, the existing IAS 11.21 rule should apply, that is: costs incurred for obtaining a contract can be capitalized if they can be measured reliably and if it is probable that the contract will be obtained.
   Costs of "abnormal amounts of wasted materials, labour or other resources" are mentioned in the ED as specific costs and cannot be capitalized. The DP did not mention these costs. Moreover, this is not the way they are dealt with internally by a company. This proposed notion **should not** appear in the final standard.

6. **<u>Credit risk and time value in price transaction:</u>**
   BC 63 states: "…the boards have articulated the proposed indicators of control from the perspective of the customer". We believe that the same perspective should be applied to the customer's credit risk element. In fact the same perspective would minimize the risk of an entity recognizing revenue from credit risk's valuation that do not coincide with the fair value of good and services transferred to the customer. In fact in IAS 11.12 the fair value is closely related by specific element such as claims, revisions, etc. while the credit risk element is not specifically and expressly considered. We agree to the way the issue is approached by IAS 11, because the fair value represents the economic value of goods and services in an arm's length transaction. In other word fair value comprises the bid price and claim's measurement in an arm's length transaction. The credit risk, instead, is a measurement component when payments become due by customer. Therefore we believe it is more appropriate to an initial recognition of the fair value of the arm's length transaction through an asset (WIP) followed by the measurement of the credit risk applied to the receivable. In addition through IFRS 7 an entity discloses credit risks on financial asset's (receivable and not WIP) which can be evaluated thoroughly by a user of financial statements. Again The ED should define when a financing component is material. For the same reason explained above, the recognition of an implicit interest income instead of contract revenue will distort the amount of contract revenues (the fair value) and creates misunderstanding for users.

7. **Internal reporting versus external presentation:**

   The adoption of this new standard will lead those companies which do not identify separate performance obligations (see 1.a) within a contract to experience a disconnection between the way their internal reporting is prepared and the new external presentation to be adopted.

8. **Extensive financial statement disclosure:**

   Also, the extensive disclosure of financial statement will increase the accounting costs, whereas it is doubtful that this extensive information will provide additional useful decision-making information to the users of financial statements.

   In particular, **we do not think** that the disclosure of outstanding performance obligation (= amount of the transaction price allocated to the performance obligations remaining at the end of the reporting period and which are expected to be satisfied in future reporting periods) will improve the quality of financial reporting. It will only forecast revenue for the contracts outstanding at that date. It will not allow forecasting revenue of cash-flows for future years, due to various reasons: new contracts awarded during the next year, hazards which delay the scheduled performance of the obligations, different pattern in performance obligations' satisfaction and cash collection, etc.

9. **Product warranty:**

   We do agree with the proposed distinction between types of product warranties.

   However, we do not agree with how a product warranty should be accounted.

   For instance, for a non-commodity industry, it is difficult to make a precise estimate of the cost to be incurred for warranty costs at inception. In the case of the construction industry, every project is unique and warranty cost cannot be estimated according to statistics. Also, product warranty is a complex issue which exposes the contractor to liability years after the contract has been completed.

   A fair presentation would be obtained if product warranties are considered as separate liabilities, rather than separate performance obligations.

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