

Engineering & Construction

Engineering Change: Potential impact of Revenue Recognition on the Engineering & Construction Industry

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"There is nothing wrong with change, if it is in the right direction."

- Winston Churchill

Contents

Background to the Revenue Recognition Discussion Paper	1
How the proposals would affect the industry and PwC's view	1
How the industry has responded	2
What happens next	3
Contacts	3
Selected quotes from the Engineering & Construction industry:	4

Preface

The model for revenue recognition is changing. Some industries may be significantly impacted. Other industries may experience less of an impact of these changes. The purpose of this publication is to outline the proposals in the new revenue recognition accounting model and to help companies in the Engineering and Construction industry understand how these proposals may impact them.

Background to the Revenue Recognition Discussion Paper

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) initiated their joint project on revenue recognition in 2002, primarily to clarify the principles for recognising revenue.

In US generally accepted accounting principles (US GAAP), for example, revenue recognition guidance comprises more than a hundred standards - many are industry-specific and some can produce conflicting results for economically similar transactions.

In International Financial Reporting Standards (IFRS), the principles underlying the two main revenue recognition standards (IAS 18 *Revenue* and IAS 11 *Construction Contracts*) are inconsistent and vague and can be difficult to apply beyond simple transactions.

The IASB and FASB issued a joint discussion paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, to invite comments on the Boards' preliminary views on a single, contract-based revenue recognition model.

The primary objectives of a single, contract based revenue recognition standard are to:

- Eliminate inconsistencies and weaknesses in current standards;
- Converge IFRS and US guidance on revenue recognition; and
- Reduce the voluminous sources of US revenue guidance.

As a result, the Boards expect that entities will recognise revenue more consistently for similar contracts, regardless of the industry in which an entity operates. Such consistency should improve the comparability and understandability of revenue for users of financial statements.

With potentially significant effects for the Engineering & Construction industry, the aim of this short paper will be to outline:

- How a new Revenue Recognition standard could affect the Engineering & Construction industry;
- PwC's industry perspective;
- How the industry has reacted to the proposals; and
- What happens next.

How the proposals would affect the industry and PwC's view

While the Discussion Paper does not include (nor was it intended to include) a full set of principles required for a final standard, it does present a number of proposals that could have a significant impact to current practice. The more significant of these proposals that might impact the Engineering and Construction industry are as follows:

Satisfaction of Performance Obligations: The Discussion Paper proposes that revenue is recognised when performance obligations are satisfied. It places emphasis on 'control' of the asset passing as being the key trigger in making this determination. What isn't clear is whether control transfer is intended to be based on a legal or economic notion. If the former, this would be an issue for the industry, as in many construction contracts legal control may not actually pass to the client until practical completion of the project. We are concerned that using a strict legal definition of control transfer, or one based only on physical control, could result in accounting that does not reflect the economic substance of transactions and provides less decision-useful information for users. A clear principle of control transfer that ensures the economics of a transaction are reflected in the accounting should be articulated, supported by indicators to assist in determining when the principle is met (whether at a point in time, or continuously over the contract term). We believe, as examples, that the following may be indicators of control transfer:

- The customer has the ability (whether exercised or not) to make substantive changes to the design of the asset during the contract period.
- The customer has the right to the asset, for example, through lien rights, title transfer or enforceable contract terms. The customer's ability to take over work in process suggests that the vendor is, in effect, continuously transferring control.

- The customer has an obligation to make non-refundable payments for work in process.

The Boards are currently assessing the extent to which indicators of control transfer should be provided in a final standard. We have provided a list of indicators, including those noted above, to the Boards for their consideration.

It is critical that the Boards also address the measurement of revenue when control of an asset continuously transfers. We believe that the Boards should consider whether existing percentage of completion guidance, using either input or output measures, accurately reflects the continuous transfer of control.

Separation of Performance Obligations: A second key impact surrounds the requirement to break a contract down into performance obligations. The Boards have proposed that performance obligations should be accounted for separately only when transferred to the customer at different times.

The discussion paper does not address the unit of account for which performance obligations should be assessed. Depending on the ultimate conclusions reached by the Boards, there may be significant impacts on systems and accounting processes.

While we agree that performance obligations should be accounted for separately if transferred at different times, we do not believe that a revenue standard should be applied to contract terms that lack commercial substance. This would include, for example, artificially segmenting a contract into individual performance obligations that do not reflect the substance of the arrangement.

Cost Capitalisation: A third key impact surrounds the recognition of contract related costs (e.g., pre-contract costs). The Discussion Paper does not include any contract cost recognition guidance. Therefore, contract related costs will be expensed as incurred, unless such costs meet the existing definition(s) of an asset. While we believe that cost guidance should not be included in a revenue standard, we believe the Boards should evaluate the adequacy of existing cost recognition standards to determine whether additional principles or guidance might be needed in those standards to address the recognition of customer contract related costs. This is especially true for contracts common in the Engineering and Construction industry.

There are also a number of areas that are not addressed in the Discussion Paper where further guidance will be needed. Some of these areas, for example measurement of continuous transfer of control, are discussed above. Foremost of the remaining areas is accounting for the inevitable change orders/variations that occur on most construction projects. The industry

traditionally treats change orders/variations as part of an overall project and adjusts overall margin accordingly. It is not clear whether this approach will remain appropriate. Perhaps equally as critical is the measurement of contract consideration; including contingent consideration. For the Engineering and Construction industry this would include prevalent items such as claims, awards and incentive fees.

The industry is also keen to understand better the requirements around discounting for time value of money, particularly given the substantial advance cash often received by contractors at the outset of major projects. Finally, the Boards have not yet addressed combining of contracts, which is also critical to ensure that the economics of a transaction are appropriately reflected.

How the industry has responded

The written responses to the IASB and FASB (including PwC's response) are a matter of public record and can be viewed on:

http://www.fasb.org/jsp/FASB/CommentLetter_C/CommentLetterPage&cid=1218220137090&project_id=1660-100.

Overall, the majority of respondents supported the objectives of this project, but many expressed concern as to whether one model can provide users with decision-useful information in all industries. This broad concern seems to stem from the perceived application of control transfer in determining when to recognise revenue.

More than 200 companies, individuals and trade industries submitted responses to the Discussion Paper in June 2009. This is a significant overall response rate as compared to the volume of comment letters to other recently proposed standards.

The Boards received comment letters from several major construction companies and contractor groups in the US, Australia, UK and Sweden, as well as individual corporations in the US, India and Australia. Respondents include: Fluor, URS, Balfour Beatty, Skanska, Brookfield, Larsen & Toubro, Laing O'Rourke, Foster Wheeler, KBR, Shaw Group, McDermott International and Lane Construction. This represents a who's who of major players in both the public and private Engineering and Construction industry.

Inevitably those that feel strongly about the issues and are most impacted by the potential change, are the most likely to respond. Consequently, it's no surprise that Engineering and Construction companies had a high response rate as compared to other industries. That said,

it is striking to see the strength of feeling and unanimity of views from the industry across so many geographies.

There are clearly differences in response, in terms of tone and detail; however there is a significant level of consistency in the thrust of the arguments posed. These messages can be summarized as follows:

- The industry has a revenue recognition standard in both IAS11 and SOP 81-1 that is:
 - widely understood;
 - has been in place for a number of years; and
 - is consistently applied.
- It is not sufficiently clear whether construction contracts would constitute the provision of a service or a good
- The proposed “transfer of control” provisions are a major cause for concern as the Discussion Paper could result in a legalistic interpretation rather than one based on commercial substance
- There are many practical issues when separating a construction project into “performance obligations”. The scope for different interpretations would potentially impact comparability of information provided to users
- Construction contracts are almost never static relationships. There is a need for more guidance on accounting for the inevitable change orders and variations that occur
- Treatment of risk sharing arrangements needs to be clarified, particularly where future changes in estimates are involved
- Current standards regarding capitalisation of pre-contract costs should be retained and clarified in any new standard.

In addition to the accounting issues raised, a number of respondents highlighted other ramifications, such as:

- The impact on taxation in various territories
- The investment in IT systems required

What happens next

The Boards have shown a real willingness to engage with the industry. We are aware of meetings with the Boards’ Staff in recent months with contacts from the US, UK, Spain, and Australia. The industry’s views are being listened to and, given the potential for such a fundamental

new standard, there will be a strong desire for the Exposure Draft to be seen as clarifying many of the issues raised and concerns expressed.

Our view is that a “carve out” from the overall standard is questionable. It is also unlikely that IAS11/SOP 81-1 will be retained as is. If that is the case, the industry will not be unaffected. We would expect changes of interpretation in the areas of performance obligations, adjustments of margin, and pre- contract costs in particular. We believe that the Boards should address the concerns unique to the construction industry as they develop a final standard.

The Boards remain enthusiastic to continue a dialogue as the Exposure Draft is developed. We would expect an Exposure Draft to emerge in 2010 and will be supporting companies in responding to it.

If you would like to discuss any of the issues contained within this paper, or generally about our services, please feel free to contact any one of us:

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Selected quotes from the Engineering & Construction industry:

Overall general comments

URS Corporation (US)

"Changing the revenue recognition model from the current one to any significantly different approach will require an enormous investment by the E&C industry to "retool", particularly to reeducate the non-financial professionals that participate in measuring revenue, not to mention the potential modifications to financial information systems tools currently in use by the industry. As such, we are concerned about the practical consideration of costs versus benefits in the Boards' deliberations on this topic."

The Associated General Contractors of America (AGC)

"After 28 years of applying the principles and guidance of SOP 81-1, the construction industry preparers and auditors along with the users of its financial statements have substantial compliance with the standards."

On control

Australian Constructors Association

"In construction activity, possession and therefore legal control of the site is maintained by the contractor in order for the efficient conduct of the construction activity. This is also reflected in the accounting of the customer, who recognises an asset under construction on their balance sheet, despite not having legal control. A move to focus on a pure legal concept of control would most likely have the impact of deferring the recognition of revenue on construction contracts until legal control has passed to the customer as completion, notwithstanding that the economic substance is that the customer receives the right to the work in progress during construction. Indeed, contracts generally contain clauses that entitle the customer to terminate works and take control of the site after making appropriate payment to the contractor for unpaid works."

The Lane Construction Corporation

"I agree with the theory of a single revenue recognition principle to ensure that similar transactions are accounted for similarly. However, I believe that a clear definition of the concept of control is needed, including a list of indicators of control, which will provide sufficient guidance for all industries. In many industries, including the construction industry, performance under the contract is a continuous process that may last a period of several years. In such circumstances, financial statement preparers need additional guidance on the indicators of continuous transfer of control."

Construction Financial Management Association (US)

"...We do not believe that the Boards' proposed definition of a performance obligation, in and of itself, provides sufficient guidance for determining deliverables/components of a contract and when control has transferred. If the construction industry is to be covered by the views presented in the Discussion Paper, then substantial additional guidance will be needed to aid in the identification of performance obligations, when control is transferred, and the related measurement of revenue."

UK & major construction companies

"...we strongly believe that the boards need to provide greater clarity as to how the proposed definition of control will be applied in practice and suggest that the boards should consider providing some implementation guidance which offers a range of indicators that can be used to assess the passing of control rather than looking for single test for revenue recognition."

On performance obligations

URS Corporation (US)

"Under the current guidance of SOP 81-1 where control is transferred continuously, our costs are considered, in essence, the performance obligations. With each service hour expended, brick installed or nail driven, we recognize revenue in conjunction with the costs incurred. However, based on the DP, we are not clear as to how we can identify the performance obligation and the level of detail of an asset transfer for which to measure each obligation."

URS agrees with the recommendation that contingent consideration be estimated at contract inception and allocated to all performance obligations. We agree with the recommendation that the measurement of these contingencies should be updated to reflect changes in the transaction price and that those changes in profit or loss should be recognized only to the extent that they relate to satisfied performance obligations."

UK & major construction companies

"As stated, we support the segmentation of performance obligations where doing so would result in more decision useful information. Where a component of a contract has been independently priced and the intention (and expectation of both parties) is to deliver that component separately but for commercial or other reasons it has been included within the terms of a larger contracts (such as where a construction contract has a separate, post-build maintenance service period), we support reporting of that performance obligation's revenue and gross margin separately. However, where performance obligations in a contract are valued at prices consistent with an existing contract and where that contract has been tendered with an overall contract margin in mind, we do not consider it appropriate or beneficial to segment that contract into multiple components and report individual gross margins."

Australian Constructors Association

"If many performance obligations are identified, how is the transaction price allocated to each obligation? Individual performance obligations are not generally priced separately and management certainly do not measure the performance of a construction project by this method. Consequently it would be extremely difficult and onerous to price each obligation and use this as a basis for revenue recognition."

The Associated General Contractors of America (AGC)

The judgment of the contractor, the contract terms, and many other factors are subjective. This subjectivity will not lead to consistency and again, intentionally or unintentionally, may lead to inappropriate revenue recognition. Guidance in the components of performance obligations that may be treated as separate measurements will be needed.

Margin

Australian Constructors Association

"Currently the DP does not provide guidance on the treatment of changes in contract margin other than when contracts become onerous. It is not uncommon for construction margins to move during the construction period. Currently, such changes are dealt with via a "true up" in the current reporting period. This true up provides a more reliable measure of earnings compared to the DP which contemplates a cost overrun being accounted for prospectively."

Pre-contract costs

URS Corporation (US)

"In many cases, a significant portion of the pre-contract costs are incurred by the performance of professional engineering activities that will ultimately benefit the proposed project, such as conceptualization, preliminary design and technical specification, and cost estimation. Hence, because such costs are integral and necessary to the ultimate completion of the project and may be material to the financial statements, they should be deferred. Separating the pre-contract costs would not be a fair representation of the true cost and income of a contract, and in measuring when a net position of a contract becomes onerous."

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