



Mr. Bruce Porter
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West Victoria 8007
AUSTRALIA

24 April 2009

Dear Sir,

COMMENTS ON IASB DISCUSSION PAPER *PRELIMINARY VIEWS ON REVENUE RECOGNITION IN CONTRACTS WITH CUSTOMERS*

Thank you for the opportunity to respond to the AASB's request for comments on ITC 18 Request for Comment on IASB Discussion Paper ("DP") *Preliminary Views on Revenue Recognition in Contracts with Customers*.

Downer EDI Limited is an Australian listed company and is a leading provider of comprehensive engineering and infrastructure management services across Australia, and around the world. It commenced operations some 80 years ago.

We believe appropriate revenue recognition is fundamental to achieving the fair presentation of the financial results of an entity and therefore are supportive of the IASB's intention to improve the existing revenue recognition guidance. However, we have serious concerns with the proposed model and its application in respect of construction contracts and we believe that the proposals as currently drafted would have a significant negative impact on all Australian construction contractors.

In formulating our responses we have been involved in developing the Australian Constructors Association responses and are fully supportive of their submission to you.

Set out below is a summary of our specific concerns with respect to the proposals set out in the DP.

Distinction between services versus goods

We do not believe that the DP adequately considers the distinction between providing goods and providing services. In our view, the construction of an asset under the customer's direction and their design requirements is more akin to the nature of a service than a good. Construction services are distinct from homogenous items that are produced for sale and that any customer may buy, without being able to specify the major structural design of the item, notwithstanding the extended length of time necessary to produce the item.

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In addition, IAS 11 *Construction Contracts* and IFRIC 15 *Agreements for the Construction of Real Estate* were specifically introduced as it was recognised that construction contracts were unique in nature and that additional guidance and disclosure was necessary. At the time these standards were issued it was determined that recognising revenue on an ongoing basis for construction contracts would provide the most useful information to the users. We believe that the DP should continue to allow this approach for construction contracts. This could be addressed by the principle that a construction contract constitutes the delivery of a service.

Concept of control and substance over form

The DP adopts a very legal approach to control. With regards to construction contracts, 'legal' control and transfer of the asset can often pass at the end of the contract. The DP's proposals would result in revenue recognition at the end of the contract. Consistent with our view above, where an asset is constructed under the customer's direction and their design requirements, it is generally more appropriate to conclude that control of the assets rest with the customer during the construction period, regardless of which party has physical title or custody i.e. control of any work in progress rests with the customer from the start of the contract.

Further, a construction contract usually entitles the customer to terminate the contract at any time, provided the constructor is paid for any 'services' provided to date. This provides further evidence that it is not appropriate to only recognise revenue at the end of the control when 'legal' control passes.

In our view, the substance of a construction contract is that the customer has rights and obligations under the contract, despite not legally controlling the work in progress. Therefore delaying the recognition of the revenue until the end of the contract does not represent the economic substance of the contract.

Construction contracts may also provide that title passes to the customer when a payment claim is submitted in respect of the items mentioned in the payment claim, however, not all items can be specified on the payment claim and therefore overall title passes on completion of the item. It is unclear, in this circumstance, how the concept of 'legal' control should be applied.

We also consider that further guidance is necessary with regards to the determination of control, especially if the IASB does not give guidance for the provision of goods versus services.

Usefulness of information presented to users

We believe the proposals in the DP would not provide useful information to the users of the financial statements because a user would be unable to assess the

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scale of the entity's transaction for that period or its performance as a result of the activities performed during that period. Current accounting principles for revenue recognition allow users to see the expected profitability of the contract and how the contract is progressing. This information is frequently used and understood by constructors and users of the financial statements alike.

In addition, management of construction companies manage their business and make decisions based on the percentage of completion basis. Most commonly the percentage of completion is determined using costs to date compared to total estimated costs and therefore management systems are focussed on the recording and monitoring of costs. In our view, even if the methodology was to change, management would continue using this approach as this is how performance of project managers is assessed and this is widely understood by management, employees, customers, financiers and analysts.

Economic implications

By not recognising the revenue as the work is performed, investors will not be able to assess the performance of the entity in relation to the activities performed. Revenue, and consequently profits, will be 'lumpy' because the results of the work performed over a number of years will only be recognised at the end of the project. This will create more uncertainty, especially in the current market conditions.

In addition, existing loan covenants, such as interest cover ratios, may be breached due to the earnings variability of the proposed approach which may be misinterpreted and lead to an increased cost of capital.

In Australia the ability to pay out dividends depends, in part, on the existence of distributable profits. Under the proposals, dividends will be deferred, in line with revenue. This will reduce the attractiveness of the construction industry to investors. For example, if a construction contract is for a substantial period of time and no revenue, and hence no profit is recognised in this period, and the investors are unable to assess the performance to date, investors will have little or no incentive or willingness to invest in the business.

This could further lead to entities focuses on shorter projects, inhibiting competition in the market for long term project or structuring of the long-term contracts to achieve a desired revenue recognition profile. In our view this is most undesirable as accounting outcomes will drive the commercial aspects of the business.

Presentation in the statement of financial position

The DP currently provides no guidance as to the presentation of the net contract position in the statement of financial position. Therefore it is unclear whether the

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DP proposes that the rights and performance obligations should be separately recognised (i.e. gross) as an asset and liability.

For example, the requirements in paragraphs S14 and S15 of the DP could be read to imply that a liability should be recognised at the inception of the contract for the obligation to deliver under the contract, as well as an asset for the rights under the contract.

In addition, if this is not case i.e. the net asset/liability at the inception of the contract is zero, we consider it essential to consider whether the asset which builds up over the life of the contract for the costs incurred is presented 'net' of any cash received from the customer or 'gross'.

In our view the 'net' position should be presented in the statement of financial position. The presentation as 'net' or 'gross' could have significant implications on existing loan covenants or the ability of an entity to raise finance. This is therefore a critical issue that should be considered by the IASB.

Potential tax implications

In Australia tax liabilities are generally based on the current accounting model. In the current environment, government is pursuing the investment and upgrading of infrastructure and in order to do this the government would likely not be sympathetic to deferring receipt of taxes based on the proposed accounting model. Recognition of deferred taxes would further complicate the financial statements and potentially confuse the user, putting further financial burden on a company which would have to run multiple systems.

Divergence from other standards

The recent amendments to IAS 40 *Investment Property* requiring an entity to fair value construction in progress and recognise any gains as the building is constructed would be contradictory to how the constructor would be required to recognise revenue (and consequently profit) under the proposals.

IAS 16 *Property, Plant and Equipment* also requires the customer to recognise work in progress on the statement of financial position as the construction progresses even though the customer does not have legal control, which indicates that the customer is entitled to or has rights to the asset being constructed and contradicts the approach of not recognising revenue by the constructor until the end of the contract.

Cost of implementation

Management currently manage construction contracts on a percentage completion basis. In our view this would continue even if the new Standard became effective.

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The new Standard therefore would require management to maintain a second accounting system for control purposes, and potentially a third for tax purposes.

Level of granularity to which 'unbundling' performance obligation should occur

It is not clear from the DP as to the level of granularity to which entities should unbundle their performance obligations. To make the preparation of the financial statements less judgemental and more comparable, the IASB should provide more guidance with respect to 'unbundling' performance obligations. For example in a construction contract would each brick laid constitute a performance obligation, or a floor of the building or delivery of the entire building itself once complete? It is currently unclear where the line would be drawn.

Implicit legal obligations and where to draw the line

The DP requires entities to recognise both explicit and implicit performance obligations arising from a contract. It is unclear as to the extent that implicit performance obligations should be included. We are concerned that including implicit obligations would mean that entities would need a deep understanding of the legal framework they are operating in and to consider all potential obligations that could possibly arise under the many different laws. Our preferred view would be to expense any costs incurred in satisfying statutory performance obligations as incurred. For example, the law might require constructors to fix any structural problems that occur in the building over its future life if found to be caused by the constructor. If the life of the building was expected to be 80 years, is it the IASB's intention that management would need to estimate these costs at the outset and include them upfront as part of the performance obligations? Is it the intention to also consider every potential health and safety obligation or other remote statutory obligation that a supplier has to its customer?

Please do not hesitate to contact me should you wish to discuss our concerns further.

Yours faithfully,



Peter Reichler
Chief Financial Officer, Downer EDI Limited