Leighton Holdings

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The Chairman
Australian Accounting Standards Board
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Dear Chairman,

ITC 18 Request for Comment on IASB Discussion Paper *Preliminary Views on Revenue Recognition in Contracts with Customers* ("DP")

Leighton Holdings Limited is the listed parent company of Australia's largest project development and contracting group. Founded in Victoria in 1949, the group includes Leighton Contractors, Thiess, John Holland, Leighton International, Leighton Properties and Leighton Asia. The Group has 37,000 employees with operations throughout the Asia-Pacific region.

Further to the matters raised by us during our participation in the AASB Roundtable on the DP in Melbourne, where we represented the Australian Constructors Association ("ACA"), we would like to take this opportunity to endorse the comments made by the ACA in their response to the DP.

We would also like to comment specifically on how the DP proposals will impact Leighton Holdings Limited and our shareholders, investors and other stakeholders.

Legal focus

We believe the DP has significant implications for Leighton Holdings Limited in relation to the timing of revenue recognition, with a significant risk under the proposed model that revenue would only be recognised at the end of a construction contract when legal control of the asset is transferred to the customer.

We consider that such an outcome would not reflect:

- The nature of construction contracts, that includes: being for the long-term; having unique structural design; and, being very different to the manufacture of goods.

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- The economic substance of activities undertaken by a contractor in a construction contracts, in turn bringing into question financial statement usefulness under the proposals and resulting in a need to increase the reporting of performance outside of the financial reports.

- The accounting by the customer who records work performed on their behalf as an asset.

- Using cost as an indicator of progress provides more relevant and reliable information than physical delivery.

Significant economic and financial impact

We believe the impact of such an outcome on Leighton Holdings Limited ("the Company"), shareholders, investors, financiers, rating agencies (as well as other construction companies) would be to significant, including:

- Volatility of earnings, with both profit and potential loss years solely due to the timing of the completion of projects, in particular large infrastructure projects that are constructed over an extended period (for example, greater than three years).

- Inability of the Company to include in its financial reports the earned profit on costs incurred and/or physical construction of works in a normal reporting period.

- Difficulty for customers, financiers and rating agencies to assess the financial performance and strength of the Company at a point in time.

- Increased difficulty for the Company to keep the investment market and investors fully informed of the progressive earnings, financial position and future outlook of the Company.

- Significant tax accounting consequences of deferral of accounting income compared to tax income paid on a progressive earnings basis.

- Potential increased financing costs due to financiers and ratings agencies being unable to assess the financial position and future outlook of the Company and thereby requiring an additional risk premium on finance costs that will have to be passed onto customers.

- An inability to provide a return to their shareholders, due to dividends being required by law to be paid from profits which will be deferred under the proposal.

- Reduced ability to raise capital from current and future shareholders and investors due to the volatility of revenue reporting and uncertainty as to shareholder returns.

- Potential reduction in share price and shareholder value compared to other industries that have more stable revenue recognition under the proposals.

Lack of guidance

We note that "changes in the contracts terms and conditions after inception" has not been addressed in the DP (Appendix C: Topics not covered in this Discussion Paper). Given the significant of such changes in construction contracts (i.e. cost escalation clauses, variations, claims, incentive payments and extension of time) further guidance on how the proposed model would deal with these items would need to be provided. We believe the proposed ACA refinements to the DP to define construction as a service (discussed below) would assist the model in addressing changes in contract terms and conditions.

We also highlight that there are other areas currently addressed in IAS11 that are not considered in the proposals, particularly guidance in relation to treatment of costs. The focus of the DP on revenue only makes it difficult to understand all the accounting entries required to be posted and the impact on the balance sheet and profit and loss.

Significant practical difficulties and implementation costs

Of major concern we see significant practical difficulties in applying the proposals and believe these would impose a high cost on contractors including:

- Need to hire and train staff to identify separate performance obligations and allocate stand-alone transaction prices in large and complex construction contracts.

- Need to develop new systems to record and track the satisfaction of separate performance obligations for financial reporting purposes that will overlay existing systems that need to remain focussed on measuring cost for monitoring management performance and remuneration.

- Increased time spent on reconciling management accounting to financial accounting.

- Increased time spent on deferred tax accounting as difference between when income is recognised for tax compared to revenue for financial reporting purposes.

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Construction is a service

We consider that the DP does not address the issue raised in 1.14 that distinguishing between goods and services is a problem in IFRS and lack of clear distinction reduces comparability of revenue.

We agree with the ACA's comments that a clear definition of construction as a service in the proposed model would help to address this issue and better reflect the economic substance of construction activity where the customer specifies the main elements of structural design.

We believe this proposed ACA refinement would also:

- Enhance the clarity of the DP for construction contracts.
- Allow the continuation of existing percentage of completion accounting for construction contracts.
- Avoid the significant economic and financial impacts of a model where revenue would be recognised at the end of a construction contract.
- Assist in addressing changes in contract terms and conditions not currently addressed in the proposals.
- Avoid some of the practical difficulties and associated costs of implementing the proposals.

Contract Origination costs

We consider that the DP's proposal that contract origination costs be expensed as incurred would not provide decision useful information for all origination costs (DP **Question 11(b)**).

We believe that design costs incurred in the tender process for a construction contract where the design will be subsequently used during construction should be capitalised when contract award is probable, as these costs are satisfying a performance obligation in the contract to provide design and payment for design costs incurred are included in the transaction price. Alternatively, we believe the allocation of the total transaction price to the remaining performance obligations would result in an overstatement.

Further, we believe that other costs incurred in the tender process for a construction contract that includes terms to specifically reimburse the contractor for tender costs incurred following award of the contract should be allowed to be capitalised when award is probable, as the payment to the contractor for costs incurred is separately included in the transaction price. Alternatively, we believe the allocation of the total transaction price to the remaining performance obligations would result in an overstatement.

Conclusion

In conclusion, we believe that if the proposals were to result in a deferral of revenue recognition when applied to construction contracts, this would reduce the usefulness of our financial reports to our stakeholders in understanding the financial position of the Company and this will be achieved at a significant cost that will eventually have to be borne by our customers.

We believe the ACA's proposed refinement to define construction as a service in the DP's proposed model would better reflect the economic substance of construction contracts whilst at the same time retaining percentage of completion accounting, avoiding the significant undesirable economic and financial impacts and helping to reduce some of the implementation costs of the proposal.

As a result we urge the AASB to endorse the ACA's refinement to the DP in your response to the IASB.

Yours faithfully
LEIGHTON HOLDINGS LIMITED

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