



AUSTRALIAN CONSTRUCTORS ASSOCIATION

ABN 63 065 806 948

23 April 2009

The Chairman  
Australian Accounting Standards Board  
PO Box 204  
Collins Street West  
Victoria 8007

Dear Sir

The Australian Constructors Association (“ACA”) was formed in 1994 to advance the interests of major construction contractors. ACA has 17 members (see Appendix 3) who have combined annual revenue of over \$40 billion and employ over 86,000 people directly with several hundred thousand more employed by subcontractors on member projects.

We appreciate 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*.

We have assessed the impact of the DP on the Australian Construction Industry. We consider that the single set of principles as currently proposed in the DP do not provide the necessary flexibility and clarity of application needed for accounting for complex long-term contracts, and in particular construction contracts when compared to the current standard IAS11 *Construction Contracts*. As such, we believe the proposals as currently drafted would have a significant negative impact on all of Australia’s construction contractors.

We believe that the nature of construction contracts, where the customer actually specifies the main elements of structural design, are very different to other commercial agreements and further specific guidance on how to apply the principles to the various types of construction contracts is required.

The following are the key issues we have with the DP as presented:

- How the control concept could be applied when considering long-term construction contracts – legal possession may not pass until completion, however there has been significant economic and physical activities undertaken prior to completion; the benefit of which has been received by the customer, which may not be reflected in the income statement.
- The construction industry is a service industry – we manage risks on constructing unique/large assets or infrastructure. Therefore will a contract result in the ‘delivery’ of a completed asset or is it a construction service that is being provided to a customer (as is agreed with the customer)?

- The proposals may lead to a separation of financial accounting and management control.
- Focus on the legal side of a contract may provide structuring opportunities and will lead to reduced comparability between entities within the same industry.
- We note that the DP does not cover a number of topics which have a specific bearing on long-term contracts (for example combining contracts, changes in the contract's terms and conditions after contract inception, gross or net presentation models, cost recognition guidance).
- We have identified a number of significant practical difficulties in implementing the proposals that would have a high cost for contractors.
- On balance, we believe that the proposals contained in the DP may lead to reduced usefulness of financial statements for users.

The above issues are discussed further in the General Commentary in Appendix A and have been incorporated into our responses to the specific questions contained in the DP (Appendix B).

We propose clarifications to the proposed model that would clearly define construction contracts. This proposed change would provide clarity that activities undertaken to fulfil a construction contract is an agreement for the rendering of a service, rather than the manufacture or delivery of a good. Further it would clarify that continuing services are provided under construction contracts and that it is not practical or relevant for performance obligations to be recognised separately. This would lead to the most relevant and reliable information whereby companies' revenue recognition profile reflects the economic substance of the performance of the contract because it is linked to the activities and progress on construction of the asset.

Yours faithfully

A handwritten signature in black ink, appearing to read 'J Barrett', with a long horizontal flourish extending to the right.

**Jim Barrett**  
EXECUTIVE DIRECTOR

## *Appendix I*

### *General commentary*

#### *Nature of construction contracts*

As reflected by their current separate treatment in IFRS (IAS 11 & IFRIC 15), construction contracts have a different nature to other commercial agreements.

Currently the proposals do not focus on construction contracts. The proposals do not seem to address the previously identified issue in IFRIC15.BC16(c) that “IAS 11 lacks specific guidance on the definition of a construction contract and further application guidance is needed to help identify construction contracts”.

While we note IFRIC’s view in IFRIC15.BC16(a) that “the fact that construction spans more than one accounting period and requires progress payments are not relevant features to consider when determining...the timing of revenue recognition” we believe construction contracts, where the customer actually specifies the main elements of structural design [IFRIC15.BC19], are very different to other contracts in that they are directly *driven by the customer*.

Construction contracts where the customer specifies the main elements of structural design have the following characteristics:

1. **Unique** – as the customer initiates a bid for the contract and then specifies the structural design, no two construction contracts will be the same. The specifications of the client will be different from one project to another and from one customer to another customer.

This contrasts to the “manufacture of goods to a customers specifications” where the customer is choosing elements from a range of options specified by the seller, such as manufacture of a car or plane of a standard design or platform with different optional extras or fit outs.

Under the proposals, this unique nature will make it difficult to consistently identify and measure performance obligations from project to project and contractor to contractor, as discussed further in response to **Question 4**.

2. **Ability to change the contract** – As the client is able to specify major structural elements of the design, before and/or during construction, construction contracts are written to enable scope changes and changes in the transaction price including:

- Cost escalation clauses
- Variations
- Claims
- Incentive payments
- Extensions of time

Under the proposals this ability to vary the design and scope will result in difficulties as the transaction price will vary during the project, as discussed further in response to **Question 10**.

### *Economic substance over legal form*

We believe the proposals will result in the economic substance of transactions not being reflected due to the prevalence of legal form in the DP in relation to control.

As discussed in our response to **Question 8**, the DP's concept of control focuses on the legal form of a contract rather than the economic substance of construction arrangements.

We believe the economic substance of construction contracts is that the customer has the rights, illustrated by the typical practice of the customer paying for work as performed, under the contract despite not having the ability to legally control work in progress.

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 at 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.

This is supported by IFRIC 15 *Agreements for Construction of Real Estate*, IE11, where it is acknowledged that when a buyer has the right to take over the work in progress during construction, this may be an indicator that the entity transfers control of the work in progress in its current state as construction progresses to the buyer.

As discussed in our response to the **AASB specific questions** below, this will result in significant uncertainty by users as to the performance of companies.

Based on our reading of the DP we are unable to determine whether a contractor is providing a good or a service. Delivery of a good will result in deferral of revenue recognition as legal control may remain with the contractor for practical considerations. As discussed in Appendix B it is our view that the contractor is providing a service.

#### *Loss of existing guidance in IFRS*

We note that the DP does not consider the following areas that are currently considered in the existing standard IAS11:

- combining contracts,
- changes in a contracts terms,
- cost recognition guidance.

We believe the loss of guidance in these areas would be detrimental.

#### *Practical difficulties in implementing the proposals*

The current IASB framework states:

“The benefits derived from information should exceed the cost of providing it.” [paragraph 44].

We believe the proposed principles would be difficult to implement in practice and involve significant cost that would be of little benefit to users of financial reports.

#### *Identification of separate performance obligations*

As discussed in our response to **Question 4**, the uniqueness, sheer size and complexity of construction contracts, including different delivery methods, would make consistent identification of performance obligations under the proposals difficult within an organisation let alone across the global construction industry.

We believe this will reduce comparability of the performance of construction companies and encourage the modification of contracts to achieve a desired revenue recognition profile.

#### *Satisfaction of separate performance obligations*

Assuming that a continuous transfer of the asset can be achieved, the satisfaction of performance obligations based on physical delivery would not always provide a good indication of the satisfaction of performance obligations compared to costs incurred. For example for a tunnel project, 80% of the costs of the project may be incurred on just 20% of the physical tunnel being bored due to difficult ground conditions. As a result measurement by reference to percentage of completion using costs would be

more relevant than to satisfaction of separate performance obligations for long-term contracts.

*New personnel and systems required*

We believe the proposals would require additional personnel (both legal and accounting skills) and development of new systems to:

- identify and record separate performance obligations for large and complex contracts [3.21-25]
- estimate stand alone selling prices for separate performance obligations [5.45-54]
- calculate the time value of money for transactions [March IASB Meeting]
- remeasure performance obligations and transaction price
- monitor current performance in satisfying performance obligations

*Existing project accounting systems and performance measurement*

While new systems and resources will be needed as discussed above, we believe these will **not** replace existing project accounting systems.

Construction revenue under current standards is relatively easily calculated, well understood and more reliable compared to the proposals as it is based on a margin applied to the percentage of completion determined by comparing costs to date to total estimated costs at completion. As a result, current systems are focused on the recording and monitoring of costs.

We do not anticipate the focus on costs of existing systems could or would change as this is how performance of project managers is measured the world over. The current cost focussed system is widely understood internally by chief decision makers, project managers, employees and subcontractors, and externally by customers, financiers and analysts.

As a result we see new systems will overlay existing systems in order to produce revenue for financial reporting purposes.

As a result of this we see a number of issues:

- Revenue may be significantly different to costs incurred (i.e., a tunnel may represent 80% of project costs but only be 20% of the project);
- Divergence between financial and management accounting resulting in reduced usefulness to users as performance measured internally will be significantly different to external measures – resulting in additional explanation of percentage of completion for shareholders, analysts, etc; and
- Differences between how the chief operating decision maker reviews performance compared to performance disclosed in the financial statements. We note that the revised IFRS 8 *Operating Segments* focuses on reporting through the “eyes of management”. We note that this proposal will create further differences between management and statutory results.

#### *Limited benefit to customers*

The additional costs of complying with the proposals are seen as having limited benefit to customers as often they are seeking pricing benefits in terms of economies of scale by combining multiple elements into one contract.

The result will be that the effort expended by contractors in identifying and measuring satisfaction of performance obligations would not be recognised by the customer and will be borne by the contractor.

#### **Refinement of the proposals - Construction as a service**

As reflected by their current separate treatment in IFRS (IAS 11 & IFRIC 15), construction contracts have a different nature to other commercial arrangements.

The Boards note in 1.14 that distinguishing between goods and services is a problem in IFRS and a lack of clear distinction reduces the comparability of revenue across entities.

We do not believe the current proposal addresses this issue, particularly in relation to construction. We seek clarification in relation to construction activity by defining construction activity as agreement for the rendering of services.

We believe the construction industry is a service industry with construction activity driven by the customer. Construction activity is only undertaken when initiated and then agreed by the customer, as opposed to creation of routinely manufactured inventory.

We discuss the idea that construction is a service in **Question 8**.

#### *AASB Specific Matters for comment*

We believe that the proposals overall would not result in financial statements that would be useful to users and the proposals are not in the best interests of the Australian economy.

#### **Financial statement usefulness**

The proposals could potentially reduce the usefulness to users due to:

- Deferral in revenue recognition despite substantial activity having been undertaken on the customer's behalf and that deferral would not reflect the significant value of work performed on the customer's behalf even when the customer does not have legal control;
- Significant uncertainty for users as to the performance of companies when no revenue is recognised in the period when significant work is undertaken. Situations could arise where a company has a loss for the year due to overheads despite having significant unrecognised revenue and profit in a project. In such a

situation we do not believe recognition of no revenue would be a “true and fair view” of the company’s performance for the period.

### **Best interests of the Australian economy**

As outlined in our general comments above we believe the practical implications of the new proposals will result in a significant cost burden to contractors with no apparent benefit to users of financial statements. More specifically, if an outcome of the DP is that revenue and profit on long-term contracts is only recognised at completion, then contractors would likely bias their activities to short-term contracts and lessen their desire to undertake long-term infrastructure projects, the outcome being that accounting drives commerce. For example, since the introduction of IFRIC15, an unintended consequence has been that many public companies have withdrawn from large scale high density property developments because of the deferral of profits.

Another potential consequence of not recognising revenue and profit progressively would be breaches of interest cover ratios due to variability of earnings which would inevitably be misinterpreted, leading to an increased cost of capital. Similarly, dividends will be deferred in line with revenue and be more lumpy, reducing the attractiveness of the construction sector as an investment class. Once again this will increase the cost of capital for the industry.



## *Appendix 2*

Set out below are our responses to the specific questions in the DP:

**Question 1: Do you agree with the boards' proposal to base a single revenue recognition principle on changes in an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?**

In principle we agree with the proposal to have a single revenue recognition model.

However, we have concerns over how this model would apply to long-term contracts, including construction contracts. More specifically, we are concerned that most construction contracts contain legal clauses that may suggest control of the asset under construction may not pass to the customer until completion. This would result in no revenue or profit being recognised as the contract progresses in favour of profit being recognised at completion.

We do not believe that recognition of the contract revenue at completion of a long-term contract provides relevant information to the users of financial reports. Refer also to comments made in **Question 2**.

We consider that there is a clear distinction between the construction of an asset under a customer's direction and specification, compared to the production of an item of inventory which is available for sale to any customer, notwithstanding both assets may take an extended period to produce. In our view, construction of an asset under a customer's direction is a service progressively delivered and is best measured by the activities in bringing the asset to fruition. If the customer can specify the major structural and functional elements of the design before or during construction, the activities performed for the customer should be the basis for assessing performance and recognising revenue, irrespective of legal control. Accordingly, the timing of revenue recognition should be progressive as those activities are provided.

If the proposed model does not allow the recognition of revenue and profit progressively for such long-term contracts, we believe the proposed model should be amended to accommodate this outcome.

**Question 2: Are there any types of contracts for which the boards/ proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?**

As noted in **Question 1**, we have concerns regarding the application of this model to long-term contracts where the asset being constructed is at the direction of the customer. If this model results in revenue being recognised on completion of a contract, then we consider that this would not provide useful information to users of the financial report.

For example, the construction of a road at the government's request can take several years to complete. The design of the road has been determined by the customer (the government), and must be completed by a specified date. The contract establishes cash instalments to be paid as the work progresses to optimise the company's working capital position. It is difficult to determine whether the model outlined in the DP would result in the continuous transfer of the partially constructed road throughout the term of the contract or on completion of the road. In our view, recognition of revenue at completion of the contract would not provide users of the financial report with appropriate information as to the performance of the company.

To provide another example outside the construction industry, the building of train rolling stock which has been structurally designed from initial conception to meet a customer's exacting specifications, but legal ownership remains with the contractor until delivery of the fleet in say year ten. If no revenue was recognised until delivery of the rolling stock, despite progress payments being made, there is no reasonable basis for investors and analysts to assess the performance of the company (nor the contract) for each of the financial periods during the construction period without significant additional reporting outside the primary financial report.

We are concerned that slightly different legal clauses in bespoke contracts will create inconsistency of reporting for contractors. Further, contracts drafted in different legal jurisdictions will exacerbate the problem, when essentially the substance of the work being performed is the same. How will companies explain these cross border nuances to investors and analysts? This would require a significant increase in reporting outside financial reports to ensure users understand underlying performance. We do not believe this outcome is consistent with ASIC's and the Financial Stability's Board drive for improved financial reporting transparency.

There has never been a time when the provision of relevant information to users of financial reports is more important. In the current economic climate, governments around the world are aggressively pursuing the upgrading and implementation of infrastructure, such as water treatment plants, road and rail transport, and power plants. If the DP results in revenue not being recognised on the construction of infrastructure projects until completion, then this may severely inhibit competition in the market as some contractors redirect their resources to projects with shorter timeframes.

**Question 3: Do you agree with the Board's definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.**

We agree with the Board's definition of a contract, and consider both written contracts and implicit contracts should be captured by the standard.

With the focus on contract it is unclear whether the proposed model would result in a "gross up" of the balance sheet, whereby a liability is booked at contract inception to recognise the obligation to deliver under the contract (similar to accounting for an executory contract). If this is the case, we would not support this outcome, as this

would artificially inflate the balance sheet for performance obligations, rather than liabilities that result in an economic outflow.

**Question 4: Do you think the boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.**

Long-term construction contracts typically do not separately specify all the activities that are required to be performed in order to satisfy the associated service obligations and/or provide the deliverables under a contract. In most instances, contracts legally require the delivery of an asset such as a road or building, and the contractor has an ongoing obligation to the customer until it delivers the completed asset. Before we address **Question 4** specifically, it is necessary that we comment on the ability to distinguish between the delivery of services or goods under long-term construction contracts.

Consider again the above example where the contractor is providing a service of constructing a road or building. To fulfil the contract, the contractor will be required to acquire materials and utilise labour to construct the asset. It is unclear in the DP whether in this situation the constructor is delivering a good or service. It is our view that the contractor is delivering a service and whilst legally the final deliverable is a good, the asset is in substance transferred to the customer on an ongoing basis, and not on completion. We expand on this view in **Question 8**.

We believe that the DP requires further guidance clarifying the practical application of a definition of a good and service, and also guidance on what constitutes 'transfer' of an asset as required in paragraphs 3.18 to 3.20. The definition of "transfer" is important in this model because it is the trigger for the revenue recognition. We believe that specific examples should be incorporated in the DP for long-term construction contracts which clearly indicate construction is a service this would help reduce diversity in practice when applying these definitions.

With this background of what we believe is the interpretation of the transfer of goods or services in relation to long-term construction contracts, we turn to the performance obligations under these contracts where such services are provided. As noted above, construction contracts typically do not separately specify all the activities that are required to be performed by the contractor in order to fulfil its obligations. The sheer size and complexity of long-term construction contracts are such that the concept of separate 'performance obligations' may be of little relevance to users and also subject to interpretation. We outline an example below to illustrate the difficulties in determining what the performance obligations are and the practical issues in consistently identifying these obligations.

A contract to construct a building where control of the building remains with the customer during construction. The contractor is delivering a service and accordingly there is continuous delivery of services and performance obligations under the contract as the building is constructed.

The performance obligations could be interpreted to be many different combinations of obligations, including:

1. Laying each individual brick;
2. Completion of the specific elements i.e. façade, air conditioning or plumbing, fit out etc;
3. Completion of individual floors; or
4. Completion of the entire building.

Each of these interpretations of what could constitute a performance obligation appears acceptable under the DP as drafted. It is clear from this example that the identification of performance obligations could vary by the decision of individual contractors. This would result in a lack of comparability of financial reporting because such wide interpretations in identification of performance obligations could translate into vastly different revenue recognition patterns.

This example raises the following questions and issues in relation to utilising performance obligations as a driver for revenue:

- What is the level of granularity that a contractor should go to when identifying performance obligations?
- The cost of implementing new systems and then running these systems to track numerous performance obligations would be significant, and we would not expect this cost to be outweighed by improved performance reporting.
- Is it really feasible to provide guidance in this revenue recognition model on performance obligations that can be applied consistently across all long-term contracts?
- 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.

In summary, we are concerned that the requirement to identify performance obligations in relation to long-term construction contracts will lead to:

- Artificial identification of performance obligations that are implicitly embedded within contracts for the sole purpose of meeting the requirements of an accounting standard. This would result in arbitrary performance obligations driving revenue recognition. It is difficult to envisage how this could then generate improved financial reporting to either users of the financial statements or management.
- Inconsistent identification of performance obligations across similar contracts which would compromise the comparability of financial statements. We set out an example in **Question 9** that highlights the difficulties in interpreting revenue within the financial statements where different accounting outcomes could occur in relation to essentially the same business activities.

- Revenue recognition that does not reflect the economic substance of the transaction. It is our view that when an entity is acting under the instruction of its customer that irrespective of when legal control of the asset is transferred, revenue should be recognised as services are provided.
- Structuring of long-term contracts to achieve a desired revenue recognition profile. This is not a desirable outcome as it highlights accounting considerations will drive commercial matters and this is not in the spirit of what the IASB is trying to achieve in this new revenue recognition model.

The above example and the issues identified thereon reinforces that contractors are providing continuous services under long-term construction contracts, and it is not practical or relevant for performance obligations to be separately identified. We strongly agree with the comments raised in paragraph 3.22 outlining the practical difficulties and accordingly suggest that the measure of the extent to which services have been continuously transferred is best measured by reference to the stage of completion. Industry practice for determining the stage of completion is by reference to costs to date compared to costs at completion. This reflects the ACA's view that progressive revenue recognition, that is linked to the activities and progress on the long-term construction on the asset, is the most relevant and meaningful driver of revenue recognition and reflects the economic substance of construction services.

**Question 5: Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?**

In principle yes as long as the definition of "transfer" is better explained. As discussed in **Question 4**, we consider the term transfer should reflect the economic substance of the transaction as opposed to passing of legal title. Otherwise if transfer purely means the transfer of the individual good delivered or service performed then our response would be no.

In addition there are concerns on how warranties will be treated as separate performance obligations. The construction industry is unique in respect to warranties as there are both statutory and contractual obligations that the contractor is responsible for. Indeed, some assets are required to satisfy lengthy "fit for purpose" performance hurdles that can extend in excess of 20 years. Accordingly estimating the exposure to such obligations cannot be based on historical patterns. Unlike a simple transaction of selling goods, the construction industry delivers services and goods to customers that are not homogenous. Therefore it would not be possible to reliably determine a pattern of warranty obligations and the extent to which that pattern would apply to future contract warranty obligations to measure deferred revenue. Instead it would be more useful to just provide for actual defects as an expense when they occur.

**Question 6: Do you think that an entity's obligations to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?**

No comment.

**Question 7: Do you think that sales incentives give rise to performance obligations if they are provided in a contract with a customer? Why or why not?**

No comment.

**Question 8: Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised services? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.**

We consider that the guidance in the DP in relation to control is insufficient to draw conclusions as to how this concept might apply to construction contracts. We are concerned that the proposed model focuses too much on the legal form of the contract rather than the economic substance of the arrangement.

In this regard, we note IFRIC 15.IE11 states that an "entity may have control over the activities related to the performance of its contractual obligation but not over the real estate itself". This might apply to a house builder constructing on a customer's land. We believe that it is important for guidance to be issued to clarify that legal ownership of land is not necessarily an appropriate trigger for transfer of control of construction activities and therefore revenue recognition.

We note that the DP model appears to be inconsistent with Service Concession Arrangements under IFRIC12 whereby the grantor of the concession records the asset on its balance sheet as the legal owner even though it does not control the asset for the period of the concession.

Further, it is unclear from the DP how the transfer of control would be determined for a construction contract. In most industries, control may be related to physical possession and this would be a logical basis for assessing the transfer of control. However, this is significantly more complex when determining when control transfers for a long-term construction contract.

For example, a contractor may contract to build a building on a customer's land. The customer agrees to progressive payment with third party certification. Legally, it may be that as the builder constructs the asset (brick by brick), control of that brick would pass to the customer once it is affixed to the site. If so, the contractor may recognise revenue progressively (i.e.: similar to percentage completion method).

However, the great majority of standard form and many bespoke construction contracts:

- provide that the progressive payment of monies by the owner to the builder are on account only and do not evidence that the builder has effectively discharged its performance obligations, notwithstanding that value is being created for the customer;
- provide for payment on a value of work completed basis;
- give the owner the right to deduct monies from payments due to builder for claims (including claims relating to works that have already been completed and paid for on an account only basis); and
- contemplate a completion regime pursuant to which an independent third party certifies that the works carried out by the builder have achieved completion, are "fit for purpose" and that the builder has otherwise satisfied its performance obligations.

Given the above, the concept of progressively recognising revenue upon satisfaction by the builder of discrete "performance obligations" (and the transfer of control to the owner) is potentially inconsistent with the terms of many standard form construction contracts. Specifically, while builders are typically paid progressively for the value of the works completed, a builder's contractual liability to the owner is generally not discharged until much later in the project when it has completed the works and the building has been certified as "fit for purpose" by an independent third party. In short, the great majority of a builder's performance obligations are ongoing during the course of the works and would be difficult to meaningfully decompartmentalise so that revenue recognition occurred progressively on the basis of the builder's satisfaction of discrete performance obligations.

Further, the concept that the builder has performed its obligation when services are "transferred" to the owner also presents issues in construction projects where components of work are so interrelated. Indeed, while the "asset" or "service" may have been delivered to, or been constructed on the owner's land and in some circumstances equipment is transferred to owners on being affixed to the land from a common law perspective, legal contracts may be redrafted to overcome the transfer of control if not paid for. Monitoring such clauses for each contract would be onerous, and require significant legal skills by preparers and auditors of financial reports.

We consider there is a need for greater clarity around the definition of control, and specifically how this is to be applied to construction contracts. There is significant uncertainty as to whether continuous transfer can be achieved, i.e. is the contractor satisfying the performance obligation as they construct an asset for a customer. Contractors are engaged by customers to construct an asset on behalf of the customer and accordingly it is unclear under the DP whether the contractor is delivering a customised product (being a good) or whether the contractor is providing construction services. If the former, then legal analysis would likely result in the "completed contracts" method being applied, whereas the latter would likely result in the "percentage completion" method.

We consider the guidance around control in any DP should specify that construction, responding to a customer's requirements, is a service.

One should also consider the accounting by the customer. As the contract progresses, the customer accrues a liability to pay for the work performed or for progressive payments with the creation of an asset (being an "asset under construction"). This is an indicator that the asset is being transferred to the customer albeit not legal control. Similarly, the customer usually makes payments after works are "certified" by the customer as acceptance of the work performed. Again, this is an indicator that the asset is being transferred to the customer over the period of the contract. On this basis, we consider that the driver of revenue for such contracts should be activity.

**Question 9: The boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.**

We have outlined the shortcomings with this approach in **Question 4**. To reiterate we do not believe that for long-term construction contracts the concept of measuring revenue when a performance obligation is satisfied is a meaningful driver for management or for users of the financial statements because of the inherent difficulties in consistently identifying and measuring these performance obligations.

To illustrate our view, consider the following two examples for a contract to construct a building and our interpretation of the revenue recognition outcome under the DP.

<i>Entity</i>	<i>Contract terms</i>	<i>Interpretation of revenue recognition profile under the DP</i>
1	Progressive handover of each floor of the building as contemplated by Example 5 of the DP. (i.e. milestone driven)	Revenue recognised on a proportionate basis as each floor is accepted by the customers.
2	The entire building is handed over at completion.	No revenue is recognised until the building is completed, certified and accepted by the customer.

This example highlights how one asset can be delivered with two different contractual arrangements for exactly the same activities and services being provided by the contractor. Legally the contracts are different but in substance, the contractor is providing the same service and accordingly should be accounted for similarly.

The DP would result in the performance of the construction contract being represented in two entities' financial statements differently; in fact it could be represented two different ways within the one entity. We question how the revenue recognition profile can differ so significantly when economically the contracts are the



same and the contractor undertakes the same activities to construct the building. Further, it is difficult to envisage how banks, analysts, investors and other users of financial statements will be able to understand why the revenue and earnings profile of these two entities differ so substantially or how to interpret year on year performance of an entity with such variability in revenue recognition. Users of the financial statements will never have visibility of individual contracts to understand that revenue is being impacted significantly due to the legal form of the underlying contract. Consequently our view is that for long-term construction contracts the decision usefulness of the performance obligation approach is jeopardised and the comparability of financial statements is also compromised.

We believe that in this example the most appropriate outcome is for both contracts to be accounted for progressively as this is most representative of performance. This is consistent with our view that the service/activity on a project is the best determinate of revenue recognition and accurately reflects the performance of the entity under a long-term contract.

**Question 10: In the boards' proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measurement of a performance obligation is updated only if it is deemed onerous.**

**a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?**

*Initial measurement*

We agree that performance obligations should be measured initially at the transaction price.

**b) Do you agree that a performance obligation should be deemed onerous and remeasured to the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligation? Why or why not?**

While we agree that a performance obligation should be deemed onerous if cost exceeds the carrying value of the performance obligation, we disagree with the assertion in 5.43 that the total amount of revenue recognised is equal to the transaction price. Variations, claims and incentive payments are an integral part of all construction contracts and they are **not** included in the original transaction price.

Variations, claims and incentive payments are not addressed in the proposals despite being clearly accounted for in IAS11. As a result we believe IAS11 better reflects current construction contracts and provides more meaningful guidance for preparers of accounts. The ED should provide guidance on such matters.

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.

We would note that using a "cost trigger" for re-measurement as suggested in 5.82 is similar to the test in IAS11; however this approach would force preparers to maintain a continued

focus on cost to complete despite revenue recognition changing to be focused on satisfying performance obligation.

**c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.**

We believe the proposed measurement approach does not provide decision useful information for variations, claims, rise/fall, early completion bonuses and progressive changes in margin. Also refer **Question 10(b)**.

**d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.**

Refer above.

**Question 11: The boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges a customer to recover any costs of obtaining the contract (e.g.: selling costs) are included in the initial measurement of the performance obligations. The boards propose that an entity should recognise those costs as expenses, unless they qualify for recognition as an asset in accordance with other standards.**

**a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contracts should be included in the initial measurement of an entity's performance obligations? Why or why not?**

We agree, refer **Question 10(b)**.

**b) In what cases would recognising contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.**

Significant external contract origination costs (over and above on-going selling costs) that are incurred as part of a competitive bidding process should be capitalised to the extent they are recoverable. Some of these costs, for example, the costs associated with developing a design solution that conforms to the required specification and will be used in the construction following the award of the contract, represent an integral part of the satisfaction of the performance obligation and therefore should be capitalised when the bid is probable of succeeding. These costs are reflected in the overall transaction price.

**Question 12: Do you agree that the transaction prices should be allocated to the performance obligations on the basis of entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?**

Refer Question 4.

Question 13: Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for the purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimates be constrained?

Refer Question 4.

### *Appendix 3*

#### AUSTRALIAN CONSTRUCTORS ASSOCIATION

##### MEMBERS

Abigroup Limited  
Boulderstone Pty Ltd  
BGC Contracting Pty Ltd  
Bilfinger Berger Australia Pty Ltd  
Bovis Lend Lease Pty Ltd  
Clough Limited  
Downer EDI Limited  
Fulton Hogan Pty Ltd  
John Holland Group Pty Ltd  
Laing O'Rourke Australia Construction Pty Limited  
Leighton Contractors Pty Limited  
Leighton Holdings Limited  
Macmahon Holdings Limited  
Brookfield Multiplex  
McConnell Dowell Corporation Limited  
Thiess Pty Ltd  
United Group Limited