

Case 12-05

[Business, Accounting](#)



MEMO: LabCo must determine if their accounting policy for the revenue treatment of its construction contracts is reasonable, if it is appropriate for LabCo to change its method of accounting for the Halibut contract from the percentage-of-completion method to the completed-contract method and how the change should be treated on the basis of the guidance provided within ASC 250, and how LabCo's accounting policy and accounting for the Halibut contract may change under IFRS if adopted in the coming year.

This memorandum will provide support for how the overall conclusion, based on the issues above, was reached. Facts Accounting Policy for Revenue Treatment LabCo is a large construction contracting firm, and negotiates all of its contracts with its customers on either a fixed-price or cost-plus basis. LabCo has developed an accounting policy for revenue recognition related to its customized construction contracts, as follows: " The Company performs under a variety of contracts, some of which provide for reimbursement of cost plus fees, and others that are fixed-price-type contracts.

Revenues and fees on these contracts are primarily recognized on a contract-by-contract basis using the percentage-of-completion method of accounting, which is most often based on contract costs incurred to date compared with total estimated costs at completion (cost-to-cost method). " " The completed-contract method of accounting is used in instances in which reliably dependable estimates of the total costs to be incurred under a specific contract cannot be made. " Change in Method of Accounting for Revenue Treatment

LabCo has entered into a contract with Halibut to build a six-axis laser cutting machine. The contract entered into was for a fixed-price and requires

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detailed and involved performance specifications. Even though this was a unique arrangement that required a great deal of customer specification, LabCo believed that with its extensive experience performing under similar contracts, including previous contract with Halibut, the percentage-of-completion method of accounting for this contract was appropriate.

After LabCo began experiencing significant difficulties in the design and manufacture of the six-axis laser cutting machine, (including design revisions, certain engineering costs needing to be outsourced, and the cost of steel used in the production of the frame of the machine rising unexpectedly) they determined that their estimate of the overall cost to complete the contract needed to be revised. LabCo expected that the overall project would incur total costs that would be in excess of the total fixed-fee contract price negotiated with Halibut.

As a result, management updated its estimates used in percentage-of-completion accounting to reflect both the cost overruns incurred as well as the cost overruns expected to be incurred, and also recorded a provision for the entire loss on the contract in the period in which it became aware that the contract costs would exceed the total contract value. After six-months, LabCo delivered the six-axis laser cutting machine to Halibut. Yet, when final test were ran using the six-axis, the machine failed to perform up to Halibut's specifications as defined in the contract.

LabCo then had to redesign, fix, and remedy the various issues with the machine. Upon notification of these continued problems, LabCo's CAO determined that total estimates of the contract costs to be incurred for the Halibut contract were no longer able to be reliably determined. Therefore, <https://assignbuster.com/case-12-05/>

the use of the percentage-of-completion method of accounting was deemed no longer an appropriate method of revenue recognition for this particular contract.

As a result, the determination was made that LabCo would switch to a completed-contract method of revenue recognition for the duration of its contract with Halibut. Analysis Percentage-of-Completion Method Based upon review of ASC 605-35-25-56, the use of the percentage-of-completion method depends on the ability to make reasonably dependable estimates, which, for purposes of this Subtopic, relates to estimates of the extent of progress toward completion, contract revenues, and contract costs.

Furthermore, according to ASC 605-35-25-57, the percentage-of-completion method is considered preferable as an accounting policy in circumstances in which reasonably dependable estimates can be made and in which all the following conditions exist: a. Contracts executed by the parties normally include provisions that clearly specify the enforceable rights regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement. . The buyer can be expected to satisfy all obligations under the contract. c. The contractor can be expected to perform all contractual obligations. ASC 605-35-25-61 states, an entity using the percentage-of-completion method as its basic accounting policy shall use the completed-contract method for a single contract or a group of contracts for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. Completed-Contract Method

Based on review of ASC 605-35-25-90, when lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. Inherent hazards relate to contract conditions or external factors that raise questions about contract estimates and about the ability of either the contractor or the customer to perform all obligations under the contract. Inherent hazards that may cause contract estimates to be doubtful usually differ from inherent business risks.

Business entities engaged in contracting, like all business entities, are exposed to numerous business risks that vary from contract to contract. The reliability of the estimating process in contract accounting does not depend on the absence of such risks. Assessing business risks is a function of users of financial statements. According to ASC 630-35-25-97, Circumstances to be considered in determining when a project is substantially completed include, for example, delivery of the product, acceptance by the customer, departure from the site, and compliance with performance specifications.

Changes to and from Percentage-of-Completion and Completed-Contract Methods Based on review of ASC 605-35-25-94, the completed-contract method is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability discussed in paragraph 605-35-25-57 or in which there are inherent hazards of the nature of those discussed in paragraphs 605-35-25-65 through 25-66.

An entity using the percentage-of-completion method as its basic accounting policy shall depart from that policy and use the completed-contract method for a single contract or a group of contracts only in the circumstances described in paragraph 605-35-25-61. In addition, 605-35-25-95 states, an <https://assignbuster.com/case-12-05/>

entity using the completed-contract method as its basic accounting policy shall depart from that policy for a single contract or a group of contracts not having the features described in paragraphs 605-35-25-92 through 25-93 and use the percentage-of-completion method on one of the bases described in paragraphs 605-35-25-60 through 25-61.

Accounting Changes and Error Corrections According to ASC 980-250-55-3, if a regulated entity changes accounting methods and the change does not affect costs that are allowable for rate-making purposes, the regulated entity would apply the change in the same manner as would an unregulated entity. If a regulated entity changes accounting methods and the change affects allowable costs for rate-making purposes, the change generally would be implemented in the way that it is implemented for regulatory purposes.

A change in the method of accounting for research and development costs, either from a policy of capitalization and amortization to one of charging those costs to expense as incurred or vice versa, is an example of that type of change. Adopting IFRS Based on review of IAS 18 - Revenue, the recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage-of-completion method.

Under this method, revenue is recognized in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognized only to the extent of the expenses recognized that are recoverable. Conclusion Accounting Policy for Revenue Treatment

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Based on the facts presented and the analysis performed, LabCo's accounting policy for the revenue treatment of its construction contracts appears reasonable. On the other hand, while it makes sense to use the percentage-of-completion method for contracts that can be reasonably estimated, the completed-contract method of accounting appears to be the "preferred" method, due to the specific criteria that must be met in order to qualify for such reasonableness under the percentage-of-completion method of accounting. Change in Method of Accounting for Revenue Treatment

Based on the facts provided and the analysis performed, it is appropriate for LabCo to change its method of accounting for the Halibut contract from the percentage-of-completion method to the completed contract method. According to the guidance (stated above), "An entity using the percentage-of-completion method as its basic accounting policy shall depart from that policy and use the completed-contract method for a single contract or a group of contracts only in the circumstances described in paragraph 605-35-25-61. The Halibut contract adheres to this policy, and because there were unexpected issues that caused for the contract to no longer be reasonably estimated, they are correct in their reasoning for changing to the completed-contract method. On the basis of the guidance provided within ASC 250, Accounting Changes and Error Corrections (provided above), this change should be treated in one of two ways: (1) If a regulated entity's change in accounting methods does not affect rate-making costs, the change would be applied in the same manner as an unregulated entity. 2) If a regulated entity's change in accounting methods does affect rate-making costs, the change would be implemented based on regulatory purposes. Adopting IFRS

If LabCo decides to adopt IFRS in the upcoming year, there will be a slight change in the Company's accounting policy, as well as their accounting for the Halibut contract. The use of the percentage-of-completion method when contracts can be reasonably estimated will remain consistent with IFRS.

However, whenever these costs cannot be reasonably estimated, instead of using the completed-contract method, IFRS states that revenue shall be recognized " only to the extent of the expenses recognized that are recoverable. " Therefore, the accounting for the Halibut contract will change under IFRS in the same way. In this instance, rather than switching from percentage-of-completion to the completed-contract method, LabCo's contract change would consist of altering the percentage-of-completion method in order to adapt to the recognition of revenue as stated by IFRS in the paragraph above.