Case 12-5

Aren’t We Done Yet?

LabCo is a large construction contracting firm that serves a variety of industrial customers that purchase machinery and equipment from LabCo. LabCo’s business primarily involves the design and manufacture of large, industrial machinery and tooling that is used by its customers in manufacturing parts and components for fighter jets, transport planes, and other aerospace-related machinery and equipment.

All of LabCo’s construction contracts involve the design, development, and manufacture of machines that are unique and customized to the specifications of its customers. LabCo negotiates all its contracts with its customers on either a fixed-price or cost-plus basis.

LabCo has developed an accounting policy to recognize revenue related to its customized construction contracts, which is outlined 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).
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> 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.

LabCo has entered into a contract with a customer, Halibut, to build a six-axis laser cutting machine that will be used by Halibut to cut airplane wings for a new fighter jet that will be sold by Halibut to a large government buyer. The contract entered into was for a fixed price and requires detailed and involved performance specifications. Upon entering into the contract, LabCo realized that this was a unique arrangement that required a great deal of customer specification to meet required performance standards. However, LabCo also believed that with its extensive experience performing under similar contracts, including previous contracts with Halibut, the percentage-of-completion method of accounting for the new Halibut contract was appropriate.

After the commencement of the new Halibut contract, LabCo began to experience significant difficulties in the design and manufacture of the six-axis laser cutting machine. Initial designs had to be redone, certain engineering costs had to be outsourced to a significant extent because of the termination of a very experienced and key member of the engineering team, and the cost of steel used in the frame of the six-axis machine had risen unexpectedly. These changes led to a revision of LabCo’s estimates for the overall cost to complete the contract, and because of these cost overruns, 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. LabCo 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. LabCo management also recorded a provision for the entire loss on the contract in the period in which it became aware that contract costs would exceed the total contract value.

After a further six-month delay in the design and construction, LabCo finally delivered the six-axis laser cutting machine to Halibut. However, when placed into a final test environment production simulation at Halibut's facilities, the machine did not perform to Halibut's specifications as defined in the original contract. LabCo was then required to redesign the machine and remedy various problems that led to the test failures experienced at Halibut's facilities.

Upon notification of the continued problems associated with the Halibut contract, LabCo's chief accounting officer, with input from members of the contract project management and engineering teams, determined that total estimates of contract costs to be incurred for the Halibut contract were no longer able to be reliably determined, and thus, use of the percentage-of-completion method of accounting was no longer an appropriate method of revenue recognition for this specific contract. Thus, a determination was made that LabCo would switch to a completed-contract method of revenue recognition for the duration of its contract with Halibut.

Required:

1. On the basis of the facts presented within the case overview, is LabCo's accounting policy for the revenue treatment of its construction contracts reasonable?

2. Is it appropriate for LabCo to change its method of accounting for the Halibut contract from the percentage-of-completion method to the completed-contract method? If so, how should this change be treated on the basis of the guidance provided within ASC 250, *Accounting Changes and Error Corrections*?

3. LabCo is contemplating adopting IFRSs in the coming year. How may LabCo's accounting policy and accounting for the Halibut contract change under IFRSs?