Job Cost Profit Recognition

By Richard L. Berry

Editor's Note: Continuing his series on Job Costing, Richard tackles the subject of Profit Recognition. The subject is broken down into sections covering accounting principles and legal requirements, the concepts that lie behind the JD Edwards approach (whether you like their approach or not), the setup required, and the month-end profit recognition process.

Introduction

Periodic profit recognition is an accounting requirement that can be quite complicated. Most people would probably view it as a necessary monthly evil, but if you set your World® or EnterpriseOne® system up correctly, you can automate the recognition process and remove some of the month end pain. It takes a while to build up the confidence that the system is actually generating the correct figures, but it is well worth the effort taken to understand the way the system works.

Profit recognition is governed by accounting standards. International Accounting Standard 11 is familiar to me. US GAAP is less familiar to me, but I believe that the two standards are quite similar. I will begin by taking a look at the semi-legal requirements of IAS.

Then, I will move on to consider the concepts that lie behind the JDE approach. Although the JDE approach may not be how all accountants would do their project costing, it is logical and consistent. It is worth 'falling in' with the JDE approach and doing it the recommended way.

Then I will consider the setup required in JDE. There are several sets of AAI that work together.

Finally, we will look at how to actually do profit recognition and look at the actual steps that you must take.

Methods of Recognition

International Accounting Standards (IAS11) state that "when the outcome of a construction contract can be ***estimated reliably***, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the ***stage of completion*** of the contract activity at the balance sheet date." Let us look at what is meant by 'reliable estimation' and 'stage of completion'.

Reliable Estimation

In the case of a fixed price contract, IAS11 identifies four conditions, when the outcome of a contract can be estimated reliably. All of these four conditions should be satisfied before recognition can be done:

(a) Total contract revenue can be measured reliably
Contract value is normally a reliable guide.

(b) It is probable that the economic benefits associated with the contract will flow to the enterprise
In other words, it is probable that the company will actually be paid for the contract

(c) Both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably
In the early stages of a contract, the costs to complete cannot be accurately assessed. It is likely that it is only when a substantial amount of work has been done that it is possible to assess the stage of completion. Most contractors would have a minimum threshold, before which they would not recognize costs or revenues. It is common, in practice, for a threshold

of 20% to be used. It would be only after the project had reached a stage of completion of 20% that costs and revenues would be recognized.

(d) The contract costs attributable to the contract can be clearly identified and measured reliably so that the actual contract costs incurred can be compared with prior estimates.
This is self-explanatory. Project costs should be easy to identify if you operate a project costing system.

Stage of Completion

The expression "Stage of Completion" is also referred to as the "percentage of completion". This is the phrase used in JDE Job Cost. Under this method, revenue is matched with costs incurred in reaching the stage of completion. This results in the reporting of revenue and costs (and therefore, profit), which can be attributed to the ***proportion of work completed***.

Contract revenue is recognized as revenue in the accounting periods in which work is performed. Costs are recognized as costs in the accounting periods in which the work to which they relate is performed.

It is possible, therefore, that a contractor may incur costs that relate to future activity. For example, he may have purchased a great deal of material but he may have done nothing with them. The materials could be in storage. No work may actually have been performed on the contract. Such costs should be recognized as an asset, perhaps called 'Stored Materials' (the expression used in JDE Job Cost).

How do we assess the proportion of work completed?

All of this begs the question "how can we assess the proportion of work completed?" How do we, in practice, calculate the percentage of completion? In practice there are three methods. Not all of these methods are adequately supported in JDE Job Cost. IAS11 also refers to these three methods. These three methods are:

Method 1: percent of cost
IAS11: "The proportion that contract costs incurred for work performed to date bear to the estimated total contract works"

This is the most common method of recognition, simply because it is the most practicable. Generally, costs incurred represent quite closely the proportion of work completed. As an approximation, therefore, ***Percent of Cost*** is an acceptable method for computing the amount of work that has actually been performed.

Under this method, total costs incurred at the end of the accounting period are compared with total projected costs and a percentage computed. This percentage is then used to compute the amount of revenue that can be appropriated for that accounting period.

All sorts of organizations may use this method, including some construction companies, building subcontractors, and ship builders.

Method 2: surveys of work performed
To calculate the percent of completion under this method, surveys may have to be carried out. These surveys are sometimes called 'valuations'. Under UK and Commonwealth construction practices, this job is performed by a quantity surveyor. Valuations necessarily involve calculations and some judgment and opinion. I do not know how, or if, this is done in USA/Canada (feedback from readers is welcome).

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