Management Adviser

Volume 9 | Number 6 Article 2

11-1972

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Recommended Citation

Arnstein, William E.; Blumenthal, Philip L.; Lindberg, Roy A.; Toan, Arthur B. Jr.; Trentin, H. G.; and Weiss, Allen (1972) "Management Advisory Services Forum," *Management Adviser*: Vol. 9: No. 6, Article 2. Available at: https://egrove.olemiss.edu/mgmtadviser/vol9/iss6/2

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This article is available in Management Adviser: https://egrove.olemiss.edu/mgmtadviser/vol9/iss6/2

MANAGEMENT ADVISORY SERVICES FORUM

Gentlemen:

May I take this opportunity to ask a few questions about acceptable ways of treating construction contracts by a corporation which is mainly in the retail business.

I work as an internal auditor for a corporation which usually has some construction going on. When a contract is signed with a contractor, the corporation debits an asset account and credits a liability account. The contractor sends in his bills as the various stages of the construction are completed. The corporation I work for then debits the liability account and credits cash. Usually a single construction costs well above a hundred thousand dollars so that construction in progress at any particular time is material to its financial position.

I think the above method is not acceptable because at the time the asset account is debited there is, in fact, no asset to record, the same argument can be made in respect to the credit of a liability account. Consequently, the corporation is overstating both its asset position and its liability. The manager of the internal auditing department agrees with me; he said that he had tried several times to make them change but that they will not.

We therefore think that we should have some valid support which can be shown in evidence, i.e., a letter from the Institute or reference to a textbook showing the acceptable ways, before we can ask them finally to change the method. I have tried to find a relevant text but I could not find any. I think the problem is so obvious that many textbooks treat only the ways that a contractor keeps his books. I think the inventory of generally accepted accounting principles too was silent on this problem.

I will be grateful if you will let me know if the present method is satisfactory and, if not, the acceptable ways of treating construction. Please refer me to relevant textbooks if you think it will help.

PANEL OF ADVISERS:

Under the auspices of MANAGEMENT ADVISER, a panel of management services advisers from leading accounting firms have agreed to answer to the best of their ability questions about any area of management advisory services with which readers would like help. Both questioners and advisers will remain anonymous. One or more of the following members of our panel are responsible for the answers published in this department:

WILLIAM E. ARNSTEIN, *Main Lafrentz & Co., New York*
PHILIP L. BLUMENTHAL, *Geo. S. Olive & Co., Indianapolis, Ind.*
ROY A. LINDBERG, *J. H. Cohn & Company, Newark, N. J.*
ARTHUR B. TOAN, JR., *Price Waterhouse & Co., New York*
H. G. TRENTIN, *Arthur Andersen & Co., New York*
ALLEN WEISS, *Laventhol Krekstein Horwath & Horwath, New York*

This answer to the question posed came from the Eastern office of a large regional firm:

The problem raised here is that the assets and liabilities entered into the accounts when the contract is signed overstate the true situation. The solution, which is extensively used in the contracting and sub-contracting fields, is to *net* the two accounts for statement presentation purposes.

Below is an example:

A
CONTRACTS IN PROGRESS

(1) $100	

CASH

	(2) $40

B
LIABILITY FOR CONTRACTS IN PROGRESS

(2) $40	(1) $100

A and B are netted so that assets and liabilities are not overstated.

(1) $100 contract is let.
(2) $ 40 is paid; netting A and B gives a debit balance of $40 for Contracts in Progress, which is the true factual situation.

By netting the Contracts in Progress against Liabilities for Contracts in Progress, after making entries for any cash paid, the company will be showing the actual assets that it has and, through a memo account, will have records of the total contract and liability still to be satisfied.

This reply was prepared by the New York office of a national firm:

The usual way of handling construction of fixed assets is to make no accounting entries which affect financial statements when the contract is signed. However, for control purposes, many companies make memo entries on a project budget sheet on which the amount of the contract is gradually reduced by the bills received. In addition, it is highly desirable that financial statements reflect as a footnote the amount of outstanding purchase commitments for fixed assets, if unusual in amount.

When bills are received from the contractor, the amount of the bill is debited to the fixed asset account and credited to accounts payable. If work has been done prior to the company being billed, it would be proper to accrue the estimated value of the work already done. This would be particularly true if the asset were put into use prior to final billing. The project budget would also reflect all billings, but this is not part of the financial accounting system. Of course, payment of bills results in a debit to accounts payable and a credit to cash.

The method used by the company is indeed an overstatement of assets and liabilities although the information given does not permit a determination of materiality.

Possibly you should point out that such offsetting overstatements tend to hurt almost all the financial ratios on which a company's strength is so often judged.

STATEMENT OF OWNERSHIP, MANAGEMENT AND CIRCULATION (Act of August 12, 1970; Section 3685, Title 39, United States Code)

1. *Title of Publication:* MANAGEMENT ADVISER.
2. *Date of Filing:* Sept. 29, 1972.
3. *Frequency of issue:* Bi-monthly.
4. *Location of known office of publication:* 666 Fifth Avenue, New York, N.Y. 10019.
5. *Location of the headquarters or general business officers of the publishers:* 666 Fifth Avenue, New York, N.Y. 10019.
6. *Names and addresses of publisher, editor, and managing editor:*
Publisher, American Institute of Certified Public Accountants.
Editor, Robert M. Smith, 666 Fifth Avenue, New York, N. Y. 10019.
7. *Owner (If owned by a corporation,, its name and address must be stated and also immediately thereunder the names and addresses of stockholders owning or holding 1 percent or more of total amount of stock. If not owned by a corporation, the names and addresses of the individual owners must be given. If owned by a partnership or other unincorporated firm, its name and address, as well as that of each individual must be given.)*
Name, The American Institute of Certified Public Accountants, (a professional association organized as a nonprofit, nonstock corporation), 666 Fifth Avenue, New York, N. Y. 10019.
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ROBERT M. SMITH
(Signature of the editor)