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20 DEC 1988

Australian Taxation Office

28 Railway Street, Chatswood
(P.O. Box 9990, Chatswood 2057)

12 December 1988

Muli Management Pty Ltd
2 Railway Parade
THORNLEIGH NSW 2120

Dear Mr Keock,

SUBJECT MATTER: ACCOUNTING FOR INCOME DERIVED BY LONG TERM CONTRACTORS

Recently you approached this office requesting a ruling. The matters for which a ruling was sought concerned the methodology employed in calculating income in respect of long term contracts and the record keeping requirements pursuant to such calculations.

At a meeting held 26 August 1988 the above matters were discussed in some detail. The following advice is now offered subject to the usual and necessary reservation that such advice does not bind the Commissioner in his application of the law. You will appreciate that when the time comes for the Commissioner to make an assessment he must apply the law as he then understands it in the light of any principle that may have emerged from the decisions of the Courts up to that time.

Methodology

The Muli Construction Management Package (Version E-7) is programmed to calculate income by reference to the profit emerging basis. The thrust of this basis is that the contractor/client estimates the profitability of each contract and the stage of completion reached at the end of the income year.

The profitability of each contract is based on a comparison of budgeted costs and the contract price whereby the determination incorporates the recognition of cost savings achieved or cost overruns sustained. Contract variations are also recognised in the determination of contract profitability.

As Income Tax Ruling IT 2450 acknowledges that the profit emerging basis is an acceptable method of returning income, reference is made to paragraphs 25 to 32 of the ruling. (The term Estimated Profit Basis is interchangeable for Profit Emerging Basis.)

Losses

It is acknowledged that both the Accounting Standard AA S11 and the Accounting Standard Review Board Statement ASRB 1009 advocate the recognition of losses up front, i.e. an estimated loss on a project is brought to account as soon as the potential loss is recognised regardless of the stage of completion at the end of the income year.

Notwithstanding the foregoing, it is considered that losses should only be brought to account in proportion to the stage of completion at the end of the income year. Reference is made to the utilisation of the term "notional taxable income" in paragraphs 26 and 31 of the Ruling and the line of reasoning implicit in such utilisation.

Discount Factor

The basis of the emerging profits method is that the contractor estimates project profitability and the stage of completion reached in calculating the income earned in the particular period. It follows that it is unacceptable to arbitrarily reduce the income calculated by use of a discount factor or any other such device.

It is understood that the program encompasses a discount factor to make allowances for uncertainties associated with project expenses. It is suggested it may be appropriate in the light of the particular experiences of a contractor to make allowances for uncertainties in the process of estimating and allocating expenses. For example, there is no objection to a contractor making an allowance for maintenance expenses whereby the estimate of maintenance expenses is merely calculated as a percentage of expenses but nonetheless is supported by previous experiences (ideally historical data should be compiled and utilised in the calculation of the effect of uncertainties).

It is appreciated that the approach embodying the use of a discount factor may produce a similar result to the approach advocated, clearly though the approach advocated facilitates a more accurate estimate of contract profitability and permits any review to focus upon the component of a discrepancy, if any, between the estimated profit and the realised profit.

Documentation

As you are aware section 262A of the Income Tax Assessment Act does not endeavour to enumerate what records should be maintained by taxpayers. The section operates to impose a general obligation that records maintained shall be sufficient to enable assessable income and allowable deductions to be readily ascertained.

The information compiled by the Muli Construction Management Package (Version E-7) was considered in the course of discussions held 26 August 1988. It was demonstrated that the program facilitates the compilation of information which includes:-

(a) Contract price and budgeted expenses for each individual contract.

9b) Revised contract prices and revised budgeted expenses.

(c) Committed (incurred) expenses for each contract.

(d) Contribution (profit) brought to account to date and the contribution brought to account in the relevant income year.

(e) The Project Cost Report Management Review, a manually prepared document, which records the assessment by management relevant to any variation in the contribution to be recognised (i.e. the contribution computed by the program is to be varied by management's assessment of factors not known to the program).

It is concluded that the information which can be compiled by the program, together with appropriate accounting records and source documentation, would satisfy the general obligation imposed by section 262A.

Advice to Clients of Muli Management

It is trusted that the foregoing advice clarifies the approach of this Office to the matters raised.

It is understood that you intend to relay this advice to the users of the Muli Management program. In this regard you are requested to incorporate a copy of this letter in your communications to clients.

Yours faithfully,

E J Withers

DEPUTY COMMISSIONER OF TAXATION