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Considerations Related to the Estimate-at-Completion Process

This is one of a series of aerospace and defense (A&D) industry spotlights. This series focuses on key accounting and operational matters relevant to companies within the A&D industry.

Overview

Aerospace and defense companies often have contracts for which revenue is recognized over time in accordance with ASC 606.¹ These contracts may require companies to develop an estimate at completion (EAC) if the cost input method (i.e., costs incurred) is used to measure progress. An EAC represents management's best estimate of the costs to complete a contract and can involve significant judgment since the EAC is the sum of actual costs incurred to date and the estimate-to-completion (ETC) costs. This spotlight identifies key considerations related to the process of developing and monitoring EACs and is intended to supplement the considerations in Deloitte's Roadmap [Revenue Recognition](#).

Components of an EAC

An EAC comprises the total revenue expected to be recognized for the contract² and the EAC costs. Costs should be identifiable at the performance obligation³ level and by type (e.g., direct labor, direct materials, subcontractors, and overhead costs). Because costs incurred are often the measure of progress for recognizing revenue, companies should remember

¹ FASB Accounting Standards Codification Topic 606, *Revenue From Contracts With Customers*.

² Revenue in an EAC should be determined in accordance with ASC 606. See Deloitte's Roadmap [Revenue Recognition](#) for more information.

³ See footnote 2.

to clearly identify any incurred costs that may not represent the overall progress of the program. For example, costs that are correlated with the measurement of progress include direct labor, direct materials, and allocation of costs directly associated with the contract (e.g., contract management and supervision). An entity must use judgment in evaluating whether certain expenses or expenditures represent progress on the contract (e.g., certain advanced payments to vendors, common inventory, uninstalled materials).

Management reserves may also be included in the EAC and should reflect specific risks that the baseline EAC estimates may not be achieved (e.g., anticipated cost growth for uncommitted materials or the risk that labor curve efficiencies may not be realized) or specific opportunities if cost savings are probable (i.e., cost synergies). An entity develops management reserves by using judgment to identify probable future risks and opportunities. Such reserves are often assigned a confidence or probability level and included in the EAC. For example, if there is a risk that the contractual schedule will slip and additional costs will be incurred, management would need to consider the probability of that slip and include the likely outcome in the reserve.

The sources of data used in an EAC vary and can include contractual documents, reports from an accounting system to detail costs incurred (e.g., labor hours, material costs), earned value management system reports, or manually prepared Excel spreadsheets. Companies should establish a clearly defined and robust process to make the estimation, compilation, and review of EACs systematic, consistent, and repeatable. Regardless of the source of the information, management should ensure appropriate internal controls exist in the EAC process to validate the completeness and accuracy of all information used.

Management Involvement

Given the diversity of information and estimates included in an EAC, various personnel from management and the functional departments should be involved in the EAC process. Such departments may include finance, purchasing, contracts, legal, business development, program management, operations, and engineering. The key to the EAC process is to avoid making high-level assumptions and instead involve the individuals in the best position to develop and validate assumptions used in the estimation process. For example, engineers would develop and review design estimates, operations leaders would review the required materials and labor to build products and develop initial estimates related to these designs, and the finance and purchasing departments would be able to apply the appropriate costs to the underlying estimates of hours. Companies should also consider the views of middle and upper-level management on expected changes to the overall business (e.g., cost reduction, scale of future operations for overhead rate purposes) when developing EACs.

All bases of estimates should be supportable, and companies should maintain documentation as evidence of the review process.

Timing of the EAC Process

Because of their evolving nature, EACs should be updated regularly to reflect management's best estimate; any changes in the estimates should be incorporated in a timely manner. EACs can be prepared by using a bottoms-up or top-down method. In a bottoms-up process, ETCs are reestimated by updating the underlying basis of estimate (BOE) for the most current information. A bottoms-up EAC is more appropriate when there is less certainty in the BOE, relatively significant changes in estimates are expected, or the company's EAC policy requires such a method. A top-down EAC affects ETC changes from a higher-level perspective. For example, if no significant changes to the estimates are expected or such changes are limited to specific ETCs, the company would only need to update those ETCs with changes in lieu of reestimating all ETCs for the period. Companies must use judgment in determining whether a bottoms-up or top-down EAC is more appropriate.

EACs should be prepared and reviewed consistently and at least as frequently as mandated by the financial reporting requirements. Common industry practice is to prepare and review a bottoms-up EAC at least annually and perform a top-down EAC in other reporting periods (i.e., quarterly). Because of the length of time companies need to prepare and review EACs, the date through which actual costs incurred are used in the EAC can vary (i.e., for a March quarter-end, developing an EAC on the basis of actual costs through December or January could be most appropriate to allow sufficient time for the process and review). In such circumstances, management must watch for subsequent events that could affect the EAC, both through the end of the financial period and until the date the financial information is available/issued. Management should have a policy in place to consider both qualitative and quantitative factors in determining when to update an EAC to reflect such subsequent events.

Cumulative Catch-Up Adjustments

Any changes in estimates made as part of the EAC update process that cause a change to the EAC margin rate will result in a cumulative catch-up adjustment to reflect the impact of the change in all prior periods on the basis of the percentage complete. These changes must be reviewed in detail to ensure that the amount and timing of the adjustment is appropriate (i.e., whether the adjustment results from new information ascertained in the current period or information that should have been known previously).

Other Considerations Related to the EAC Process

The following are some best practices for the EAC process:

- Consider the different information used and the nature of the review performed for contracts with different fee types (e.g., fixed, award, cost incentive, schedule incentive, or performance incentive fee structures).
- Ensure that the EAC is based on the most current information by consistently monitoring any contract modifications, change orders, etc., that could change the contract value (EAC revenue), scope of work, or fee structure. Submission of requests for equitable adjustments, claims, or contractual liquidated damages could potentially also have an impact on EAC revenue.
- Consider the benefits of setting a threshold related to identifying a population of contracts for which an EAC is not required or is required less frequently (e.g., contracts with a total contract value below \$1 million). In setting such a threshold, management would use judgment and consider the contract portfolio, average contract value, and other factors.
- Ensure that the process and review are consistent for contracts with similar characteristics (e.g., product, service, contract type).
- Use available historical information, such as contracts with similar scopes of work and deliverables, to help develop a basis for cost estimates and risks and opportunities present on similar contracts.
- Retain evidence of the development and review of the EAC for both internal records and to support internal and external audits.

Please reach out to the Deloitte & Touche LLP contacts below if you have any questions related to the EAC considerations discussed in this publication.

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