Case 02-3

Frequent Fixer

Frequent Fixer is a heavy equipment manufacturer. During 2000, Frequent Fixer participated in an industry benchmark study, conducted by a key competitor, of the accounting policies used for the accrual of product liabilities. Based on the results of the benchmark study, Frequent Fixer noted that the majority of companies in the industry accrue for the costs of product recalls at the time of sale.

Frequent Fixer's accounting policy for the accrual of the costs of product recalls consists of two methods. The first is the accrual of "small campaigns" that are subject to a threshold of $100,000 (total campaign costs per product). Small campaigns are estimated and recorded together with the warranty reserve at the time of sale. The second is the accrual of "major campaigns" when announcement of the recall campaign is made. A major campaign involves consideration of numerous variables (for example, the number of defect occurrences, public safety issues, public relations concerns, evaluation of potential litigation, and so forth) and requires management approval prior to being announced.

As a result of the benchmark study, Frequent Fixer began an internal evaluation of their product recall costs and their ability to reliably estimate and record product recall costs at the time of sale. The following summarizes the costs of announced product recall campaigns by Frequent Fixer in recent years:

1995	$ 8,000,000
1996	$ 11,500,000
1997	$ 15,500,000
1998	$ 20,000,000
1999	$ 32,000,000
2000	$ 50,000,000

From the data above, Frequent Fixer identified that the frequency and size of product recall campaigns, either voluntarily or mandated by industry regulators, have increased significantly in recent years. Frequent Fixer believes that the increased frequency and costs of product recall campaigns are the result of increases in regulatory activity, the focus on customer satisfaction, and the competitive pressure to perform outside of the contractual warranty coverage period.

As a result of the internal evaluation, Frequent Fixer is proposing to change its accounting policy for major campaigns to recognize a liability at the time of sale to be consistent with small campaigns. Frequent Fixer believes the change in the business environment (i.e., the increased frequency and costs of product recall campaigns), better information, and more experience (historical data) now available allows management to estimate with reliability the costs of future product recalls at the time of sale. Frequent Fixer further believes that an estimate of future product recall costs based on historical

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experience can be actuarially supported and has engaged an actuary to perform such an analysis. (This is similar to a warranty reserve, self-insured product liability reserve, or incurred-but-not-reported (IBNR) claims reserve.) Frequent Fixer believes that recognizing the costs of product recall campaigns in the period of sale is a preferable method because product recalls are inherent to the industry, are predictable based on historical experience, and provide a proper matching of revenues and expenses in the period of sale. Further, this method is preferable because it is supported by industry practice.

Required:

- The client has requested that you conduct research and make a recommendation on the appropriateness of the proposed accounting.

- If it is a proposed accounting change, is the change a change in accounting principle? If so, is it a preferable method or a change in accounting estimate?

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