



CPAs AND ADVISORS



LET'S THRIVE TOGETHER

April 21, 2015



GAAP
CONSTRUCTION
ACCOUNTING

PRESENTED BY:

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Presenter Profile

KATHLEEN BALDWIN, CFA, CCIFP Member

Profile

Kathleen has more than 15 years of experience in public accounting. She is a leader within the Firm's Construction Practice Group, which focuses on the delivery of accounting, auditing, tax and consulting services to the Firm's construction industry clients.

Ask Me About

- How to improve your company's bonding capacity
- The specifics of an indirect cost rate audit needed for DOT contracts
- Ways to protect your small business from fraud

TODAY'S TOPICS INCLUDE:

- Revenue recognition models for contractors (current)
- WIP schedules (Work in Progress)
- Advanced financial reporting issues for contractors
- Determination of job completion date for GAAP
- Special GAAP financial reporting considerations for contractors
- Footnotes and disclosures
- Revenue Recognition (future)



REVENUE
RECOGNITION

REVENUE RECOGNITION

- Two methods of revenue recognition for contractors:
 1. Completed contract method
 2. Percentage of completion method (POC)



REVENUE RECOGNITION

1. Percentage of completion (POC) method

- Preferred method assuming costs to complete and the extent of progress towards completion are “reasonably dependable”
- Income from the performance of the contract is recognized as the contract progresses and the recognition of revenue and profit on a contract is related to the cost incurred or activities performed in provided the services required. Several methods to calculate percentage completion

REVENUE RECOGNITION

1. Percentage of completion (POC) method

- In practice, several methods are used to determine or calculate the POC and SOP 81-1 does not require any specific method. Different methods are appropriate based on the different facts and circumstances of each contractor.
 - Cost to cost method (most common)
 - Efforts-expended method (labor hours, labor dollars, machine hours, or material quantities). Best for contractors that believe profits are earned from efforts and not from the costs incurred, specifically materials.
 - Units-of-delivery method (ratio delivered to total expected); paving contractor – cubic yards of pavement laid for hwy.

REVENUE RECOGNITION

POC calculation:

Contract Amount	\$100,000	
Total Direct Costs To Date	50,000	55.56%
Estimated Costs to Complete	<u>40,000</u>	
Total Estimated Direct Costs	90,000	
56% Complete		
Revenue Earned To Date	\$ 55,556	

REVENUE RECOGNITION

2. Completed contract method

- This is not an appropriate GAAP method unless:
 - Can not be used unless results do not vary materially from POC
 - Persuasive evidence that estimates are not reasonably dependable
- GP on performance is not recognized until the contract is completed. Activity remains on balance sheet.

REVENUE RECOGNITION

A contractor may use POC method as its general policy and use completed contract for a specific contract that reasonably dependable estimates cannot be developed.

Example: Ship Fire

GAAP Construction Accounting

CONTRACTS IN PROGRESS - WIP

ABC Contractor															
SCHEDULE III - CONTRACTS IN PROGRESS															
FOR THE YEAR ENDED DECEMBER 31, 2014															
Job	TOTAL CONTRACT		FROM INCEPTION TO DECEMBER 31, 2014					AT DECEMBER 31, 2014		FOR THE YEAR ENDED DECEMBER 31, 2014					
	Revenues	Est. GP (Loss)	Revenues Earned	Total Costs of Revenues	Gross Profit (Loss)	Billed To Date	Estimated Costs to Complete	Costs and Billings in Excess of Estimated Earnings	Costs and Billings in Excess of Estimated Earnings	Revenues Earned	Direct Costs of Revenues	Indirect Costs of Rev	Total Costs of Revenues	Gross Profit (Loss)	% Comp.
A	46,750	5,042	44,239	39,468	4,771	44,627	2,240	-	388	27,442	20,597	3,419	24,016	3,426	94.63%
B	1,184,821	134,119	698,562	619,487	79,075	947,785	431,216	-	249,223	698,228	531,024	88,154	619,178	79,050	58.96%
C	1,073,692	191,742	1,069,396	878,421	190,975	1,056,720	3,529	12,676	-	958,221	771,012	6,347	777,359	180,862	99.60%
D	55,177	10,031	16,685	13,652	3,033	22,132	31,494	-	5,447	16,685	11,708	1,944	13,652	3,033	30.24%
E	118,000	14,047	3,080	2,713	367	13,532	101,240	-	10,452	3,080	2,327	386	2,713	367	2.61%
SM	96,565	9,370	64,378	58,131	6,247	55,405	29,064	8,973	-	64,378	49,855	8,276	58,131	6,247	66.67%
Tot.	2,575,005	364,351	1,896,340	1,611,872	284,468	2,140,201	598,783	21,649	265,510	1,768,034	1,386,523	108,526	1,495,049	272,985	



Components of the WIP Schedule

BILLING

- Overbilling
 - Billings in excess of costs and estimated earnings
- Underbilling
 - Costs and estimated earnings in excess of billings

UNDERBILLING IS **NOT** NORMAL

- Costs and estimated earnings in excess of billings (underbilling) is usually unrecognized loss
- Overbillings should be in the “Bank”
- Must be supported by contract fade/gain analysis and historical profit percentages
 - Analytical procedure performed by accountant and surety

Determination of...

JOB COMPLETION DATE FOR GAAP

- A contract is determined completed when:
 1. All significant work on the contract has been done,
 2. The specifications under the contract have been met, and
 3. No significant risks remain
- Indication of substantial completion may be acceptance by the customer, production or performance that meets contract specifications, or departure from the site.

WIP Schedules

FADE/GAIN ANALYSIS

ABC Contractor
Contract Fade Analysis
Three Years Ended December 31, 2002

Job #	Contract Description	Est. / Actual GP		Est. / Actual GP		Est. / Actual GP		Est. / Actual GP		Contract to Date Profit Gain / (Fade) %	Contract to Date Profit Gain / Fade %	Yearly Profit Gain / (Fade) 2000	Yearly Profit Gain / (Fade) 2001	Yearly Profit Gain / (Fade) 2002
		12/31/99	%	12/31/00	%	12/31/01	%	12/31/02	%					
UNCOMPLETE @ 12-31-99														
99-021	Pleasant Ridge, Phase	14,346	8.5%	21,590	16.4%	-	-	-	-	7,244	50.49%	7,244	-	-
99-022	GLM - Phase I	29,250	4.3%	53,600	4.0%	49,073	3.6%	-	-	19,823	67.77%	24,350	(4,527)	-
99-023	Hunter Street Extension	193,446	3.5%	196,844	3.3%	225,333	3.5%	234,109	3.7%	40,663	21.02%	3,398	28,489	8,776
99-001	Various Repair Work	38,624	9.1%	34,581	7.4%	-	-	-	-	(4,043)	-10.47%	(4,043)	-	-
		<u>275,666</u>		<u>306,615</u>		<u>274,406</u>		<u>234,109</u>		<u>63,687</u>		<u>30,949</u>	<u>23,962</u>	<u>8,776</u>
UNCOMPLETE @ 12-31-00														
00-002	Pinnacle Peak, Phase III			71,908	6.0%	74,699	6.2%	-	-	2,791	3.88%	-	2,791	-
00-007	Savannah Parkway			184,631	12.7%	190,758	13.0%	-	-	6,127	3.32%	-	6,127	-
00-023	Main Street Phase IV			105,869	5.7%	135,383	7.4%	122,940	6.7%	17,071	16.12%	-	29,514	(12,443)
00-029	River Bend Underpass			-		117,161	5.7%	119,339	5.7%	2,178	1.86%	-	-	2,178
				<u>362,408</u>		<u>518,001</u>		<u>242,279</u>		<u>28,167</u>		<u>-</u>	<u>38,432</u>	<u>(10,265)</u>
UNCOMPLETE @ 12-31-01														
01-005	Savannah Parkway, Phase II					295,572	4.0%	225,000	2.0%	(70,572)	-23.88%	-	-	(70,572)
01-006	Valley View Avenue					142,883	5.6%	135,407	5.2%	(7,476)	-5.23%	-	-	(7,476)
01-012	Riverchase Ridge Extension					111,667	17.3%	128,223	19.8%	16,556	14.83%	-	-	16,556
01-015	Meadowbrook Road					268,785	6.3%	-	-	-	-	-	-	-
01-036	North Metro Park					106,048	3.8%	150,310	3.8%	44,262	41.74%	-	-	44,262
						<u>924,955</u>		<u>638,940</u>		<u>(17,230)</u>		<u>-</u>	<u>-</u>	<u>(17,230)</u>
UNCOMPLETE @ 12-31-02														
01-024	Atkinson Road							149,503	5.7%	-	0.00%	-	-	-
01-037	Crosspoint Parkway							105,476	4.8%	-	0.00%	-	-	-
02-008	North Metro Park-Phase II							222,893	4.4%	-	0.00%	-	-	-
02-014	Eagle's Landing Road							530,051	4.8%	-	0.00%	-	-	-
02-029	Perry Avenue							147,843	5.7%	-	0.00%	-	-	-
								<u>1,155,766</u>		<u>-</u>		<u>-</u>	<u>-</u>	<u>-</u>
TOTALS											30,949	62,394	(18,719)	



Unique GAAP Issues for Contractors

CONSTRUCTION ACCOUNTING

- GAAP for contractors goes back to the issuance of ARB 45 in 1955. The current source of GAAP for the construction industry is as follows:
 - Accounting Research Bulletin No. 45 (ARB 45), Long Term, Construction-Type Contracts
 - AICPA Statement of Position 81-1: Accounting for Performance of Construction-Type and Certain Production-Type Contracts

ACCURATE JOB COSTING IS CRITICAL

- Full absorption job costs (everything except G&A)
- Allocation of indirect costs must be systematic and rational; labor burden, equipment, shop, bidding, etc.
- Cost shifting is dangerous (shifting costs from job to job)
- Cost plus contracts: exposure of owner audit

CLAIMS & CHANGE ORDERS

- Changes to the initial contract that are initiated by the owner/customer or contractor.
- Classifications of change orders:
 - Approved change orders
 - Unapproved change orders & claims
- Approved change orders (owner has approved scope and price) increase the contract amount (recognize revenue & gross profit) and the costs are accumulated in the job-to-date costs for the project.

CLAIMS & CHANGE ORDERS

- **Unapproved change orders and claims** should only be recognized into revenue when the following four criteria are all met:
 1. The contract or other evidence provides a legal basis for the claim; or a legal opinion has been obtained, stating that under the circumstances there is a reasonable basis to support the claim.
 2. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance.
 3. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed.
 4. The evidence supporting the claim is objective and verifiable, not based on managements "feel" for the situation or on unsupported representations.

LOSS JOBS

- In the period in which a job is estimated to have a loss the entire amount of the loss is recognized immediately regardless of whether you are 5% or 95% complete with the project.
 - The accrued loss becomes an overbilling as calculated by the work-in-process schedule.
- Applicable to both percentage of completion and completed contract revenue recognition methods.

COMBINING & SEGMENTING CONTRACTS

- There may be certain cases under SOP 81-1 that contracts may be combined or segmented for GAAP financial accounting purposes.
 - The presumption is that each contract stands alone as a separate profit center
 - Combining and segmenting contracts could significantly change when revenue and gross profit are recognized during the course of the contract(s)
 - Combining contracts (happens occasionally)
 - Segmenting contracts (very rare occurrence)

LIQUIDATED, OTHER DELAY DAMAGES AND PENALTIES

- Included as part of the contract terms and conditions. The longer the life of a job, the more exposure there is to the contractor for penalties and liquidated damages.
- Can affect cost estimates, percentage complete, and revenue.

BACK CHARGES

- Back charges should be accounted for as follows:
 - Back charges to others (we incurred the cost and want to bill another contractor) should be recorded as receivables and to the extent considered collectible should be applied to reduce contract costs.
 - Back charges in dispute should be accounted for as a claim.
 - Back charges from another (another contractor incurred the costs for something that we were to perform and they want to bill us) should be recorded as payables and as additional contract costs to the extent that the amounts will be paid.

INDIRECT OVERHEAD ALLOCATION

Expenses categories of a typical contractor:

1. Direct contract costs

- Direct materials, direct labor, subcontractors, equipment rent, equipment usage charges, job overhead, and other direct costs

2. Indirect contract costs

- Indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and other indirect contract costs
- SG&A / overhead costs are generally treated as a period cost and are not allocated to jobs

GAAP REQUIREMENTS FOR ALLOCATION

- ARB-43 states that if costs cannot be “clearly related to production”, they should be regarded as period costs.
- If the cost can be specifically identified to individual contracts and individual tasks within those contracts then is cost of earned revenue.
- If the cost can be specifically identified to individual contracts, but not tasks within those contracts then is cost of earned revenue (job overhead, other direct, equipment pools).

GAAP REQUIREMENTS FOR ALLOCATION

- If the cost cannot be allocated to either individual contract or a task within a contract it is considered G&A.
- Indirect costs should be allocated to contracts in a systematic and rational way. The most common methods of allocating indirect costs include allocations based on direct labor hours, direct labor dollars, total direct contract costs, etc.

15% MARKUP AND STILL LOSING \$\$?

- Revenues \$3,500,000
- Direct Costs (excluding indirect allocated) - \$3,000,000
- SGA (gross) - \$1,000,000
- Net Loss (\$500,000)



FOOTNOTES AND DISCLOSURES

CONSTRUCTION ACCOUNTING

- Unique schedules included in financial statements
 - Supplemental contract schedules
 - Backlog disclosures
 - Claims and change orders
 - Gross Profit Reconciliation

CONSTRUCTION ACCOUNTING

- Revenue recognition policies:
 - You must disclose whether you use the percentage of completion method or contract method, how it was calculated and the reason for using the method
- Contractors are encouraged (not required) to disclose backlog information for contracts that have not been started, have been signed, and cancellation is not anticipated.
- Disclose retainage receivable separately either on the balance sheet or in the footnotes.

CONSTRUCTION ACCOUNTING

- Disclose receivables from completed and uncompleted contracts separately. Also disclose Unbilled AR.
- If receivables include amounts maturing after one year:
 - You should disclose the amounts maturing each year and the interest rates on major receivable classes, if applicable.
 - This also applies to retainage receivable.
- Disclosures for contingent gains or losses related to unapproved change orders or claims



GOOD ACCOUNTING
INFORMATION

ISSUES & STRATEGIES FOR RECESSION

- Good accounting information is more important than ever
 - Bonding companies are reporting record losses
 - Construction company failures are at record highs
 - Backlog and margins are down
 - Claims and litigation are up
 - State revenue departments are more aggressive
 - Owners and Prime Contractors are more skeptical

GOOD ACCOUNTING REQUIRES:

- Timely and accurate financial statements
- Good job costing and job schedules
- Underbilling is bad
- Overbilling is good. Overbilling should be in the bank
- Cash flow reports by job. Investigate negative cash positions

GOOD ACCOUNTING REQUIRES:

- Fade / gain analysis
- Project manager meetings to revise estimates and investigate change orders, claims, collection problems, etc.
- Consider bonus programs for best job management
 - Highest cash flow
 - Lowest job fade
 - Best change order
 - Lowest bid spread

REVENUE RECOGNITION - FUTURE

Revenue from Contracts with Customers – Topic 601
No. 2014-09 issued May 2014

- U.S. public companies - for annual reporting periods beginning after December 15, 2016.
- U.S. private companies - for annual reporting periods that start after December 15, 2017, but can choose to adopt the new standard as early as periods beginning after December 15, 2016.

Proposed: postpone 1 year for each

REVENUE RECOGNITION - FUTURE

The guidance in this Update **supersedes** the revenue recognition requirements in Topic 605, Revenue Recognition, and **most industry-specific guidance** throughout the Industry Topics of the Codification. Additionally, this Update supersedes some cost guidance included in Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts.

REVENUE RECOGNITION - FUTURE

Key Points:

Identify performance obligations – potentially break about a contract

New terminology – variable consideration, distinct function, performance obligation, fulfillment costs; just to name a few

REVENUE RECOGNITION - FUTURE

You have time, but know it's coming.

Be Prepared



QUESTIONS?

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