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UPDATING/IMPROVING SOP 81-1 AND THE AICPA AUDIT AND ACCOUNTING GUIDE – CONSTRUCTION CONTRACTORS

WHERE I STAND

For more than 20 years, I have taught various construction accounting groups and trade organizations about the importance and relevance (as well as the shortcomings and omissions) of SOP 81-1 and the related AICPA Audit and Accounting Guide – Construction Contractors (the Guide).

In my opinion, both SOP 81-1 and the Guide should be rewritten to reflect the dramatic changes that have occurred in the construction industry over the past 28 years.

I continue to warn CPAs that construction accounting has changed and that while certain procedures and disclosures have become “generally accepted” in the industry, SOP 81-1 and the Guide have not kept pace.

Though the latest version of the Guide was released in May 2009, a complete overhaul is appropriate and long overdue. This article describes specific areas that need revision, in addition to brief summaries of my recommendations.

RISK ASSESSMENT

Both SOP 81-1 and the Guide lack critical information on how to calculate and assess a contractor’s most significant risk: the percentage-of-completion method (PCM) for income recognition and the related estimates of cost, profit, and percent complete.

Other than Exhibit 10-3, the Guide neither describes nor contains examples of contract risk assessments that use fade/gain analysis, historical gross profit analysis by contract type, historical tracking of significant changes in estimate, etc.

The most important analysis and work paper example used for contract risk assessment is not covered in the Guide, when in fact, an entire chapter should be dedicated to these procedures.

Note: The failure of contractors to understand and document risk assessment for contract estimates (and related procedures) is the most widespread audit failure.

DIFFERENT PROCEDURES FOR DIFFERENT TYPES OF CONTRACTORS

A construction contractor may specialize in general contracting, heavy/highway, civil, industrial, mechanical, roofing, electrical, homebuilding, or landscaping. And, even though the audit procedures and risk assessment issues are different for each specialty, the Guide does not describe procedures specific to contractor type.

For example, since GCs subcontract 80-90% of their work, the risk assessment process should focus on subcontractor pre-qualification and management. Likewise, a heavy/highway contractor’s major cost is equipment, so procedures should focus on equipment depreciation, leases, costing, fuel management, etc. Therefore, a brief chapter that details the various procedures unique to contractor type is much needed.

DISCLOSURES

Many of the disclosure requirements prescribed by surety bond companies and other significant users of a contractor’s financial statement are barely mentioned or omitted entirely. For example:

- 1) The example in Appendix E about Change in Accounting Estimate (FAS 154 and SOP 94-6) uses a poor format and lacks full disclosure.

This is important because the SOP 94-6 disclosure of the current year and cumulative impact to earnings caused by significant contract gross profit gain or fade could have a significant impact on a user’s conclusions.
- 2) FIN 45 disclosures for Guarantees are omitted. Since contractors regularly guarantee the performance of subcontractors to contract owners, the failure to obtain subcontractor bonds creates significant contingent liabilities for contractors. Contractors also purchase self-insurance and large-deductible policies that have significant potential off-balance sheet liabilities.
- 3) The Backlog disclosure format is antiquated and lacks information relative to the amount of backlog subject to surety bonds, the amount subcontracted to others, backlog gross profit, etc.



In addition, only the gross amount is illustrated in the disclosure – even though backlog gross profit is more important and meaningful to most users.

- 4) The Guide does not mention the potential disclosure requirements for significant cash distributions for the tax liabilities of pass-through entities (S corporations and LLCs) – even though the most important basis for surety credit is working capital. The Guide should address this “generally accepted” disclosure that significantly impacts surety credit analysis.
- 5) There are no specific instructions about the disclosure requirements for indirect cost allocations, equipment cost allocations, under- and over-allocations, and related methods. This needs to be remedied.
- 6) The Guide should also address the significant disclosure requirements of revenue recognition from claims and unapproved change orders. Other than a brief reference in the receivable disclosure of Appendix F, this important disclosure is not discussed.

THE NEEDS OF SURETIES

Since the surety industry is the credit community’s leader in analyzing construction financial information, an entire chapter should be dedicated to surety analysis and disclosure, including illustrations of surety credit calculations and risk assessments. The Guide should give CPAs more information about the surety process and its related financial, audit, and accounting issues.

FINANCIAL STATEMENT FORMAT & SCHEDULES

All CPAs with construction experience understand the extreme importance of working capital to contractors and their sureties, yet the Guide’s Appendix F Sample Financial Statement still illustrates an unclassified balance sheet. Not only is this example misleading to practitioners, but it also reflects a complete lack of understanding of the industry. Why? Because most major sureties and licensing boards will reject an unclassified balance sheet.

Licensing boards, sureties, banks, and contractors all consider the working capital calculation to be the basis for bidding capacity. Simply put, it is *the most important* balance sheet requirement. The Guide should not encourage CPAs to hide from their responsibility to substantiate and report working capital. The entire Sample Financial Statement should be

completely revised to reflect current trends and best practices in the construction industry.

ACCOUNTING METHODS

One of the most significant problems with the Guide occurs in the Chapter 2 discussion about using the PCM or the completed contract method (CCM). Some practitioners and contractors could incorrectly interpret the Guide to allow the CCM as an “either/or” alternative to the PCM.

While the Guide does not allow this, its use of the word “recommend” in paragraph 2.07 is weak and misleading. Another major problem: The Guide does not remind CPAs that the use of the CCM requires significant disclosures and possibly a qualified audit opinion. In fact, if the CCM is used for “lack of reasonably dependable estimates,” then a qualified audit opinion for significant internal control impairment will be required.

JOINT VENTURES

Even though Chapter 3 is one of the most adequate in the Guide, it stops short of emphasizing the requirements of FIN 46(R) related to consolidation of variable interest entities. In my experience, joint ventures usually meet the requirements to be consolidated due to the risk of loss and thin capitalization.

There are additional discussions of joint venture reporting in paragraphs 11.03 and 11.04, but these paragraphs fall short, as well. The generally accepted and most accurate method is “partial or proportionate consolidation,” which is described briefly in paragraph 3.13.

Partial consolidation is the only method that does not distort working capital, revenue, or backlog information; accordingly, it is preferred by sureties and other users. Joint ventures are very common in today’s construction environment and this is a significant reporting issue. The Guide should provide more information on partial consolidation and related disclosures.

CONSTRUCTION EQUIPMENT

Equipment costs make up approximately 20-40% of total costs for heavy/highway and civil contractors. Other than a brief and inadequate comment in paragraph 8.24 (and a few other references), equipment costing is barely mentioned.

Such issues as useful life estimates, idle equipment costs, repair and maintenance calculations, and internal allocation

rental methods are omitted. In my experience, major revenue recognition errors and audit failures occur over equipment costing issues.

INTERNAL CONTROLS

Chapter 8 is too general and does not describe the internal controls used to manage: subcontractors (material lien verification, bonds, etc.), equipment costing (allocation methods, capitalization, etc.), bidding and estimating controls, and other areas.

Although Chapter 8 mentions some of these controls, no details are included. The lack of any discussion about the most significant control – historical fade/gain analysis – is a major omission. More emphasis should be given to those jobsite internal controls that have become such major industry issues.

The Guide was written before modern computer software was implemented. Accordingly, it should address such construction software controls as phase codes, contract budget variance reports, labor reports, etc. The entire section on internal controls should be revised.

CONTRACT SCHEDULES

The completed and uncompleted contract schedules are the most important disclosures in a contractor's financial statement. The Guide clearly recommends their inclusion as supplemental disclosures. Stronger wording is needed to remind practitioners that exclusion does not lessen their responsibility or liability for the schedules.

Many CPAs mistakenly see these schedules as optional and erroneously believe that inclusion will increase their liability. However, the opposite is true – inclusion of the contract schedules is now considered mandatory by sureties and other users.

The Guide should dedicate an entire chapter to the contract schedules and related computation issues (claims, change orders, cost-plus, loss jobs, etc.). Appendix G is a start, but it should be expanded.

CLAIMS & CHANGE ORDERS

The vague criteria for claims and change order recognition found in paragraphs 65-67 of SOP 81-1 are routinely interpreted incorrectly. More emphasis should be given to a method of recognizing claims and change orders when collection is highly probable.

Many CPAs mistakenly include claim costs on contract schedules and inadvertently recognize profit on claims in violation of SOP 81-1. Revisions are necessary to both SOP 81-1 and the Guide to reduce the reporting and income recognition errors related to claims and change order recognition. Also, the contract schedule exhibits should include illustrations of jobs that contain claims and change order billings (and the related disclosures).

SUMMARY

In summary, SOP 81-1 and the Guide have served CPAs and the construction industry well for more than 28 years. However, it's time that these documents reflect the disclosures and methods that have become "generally accepted" in the construction industry. **BP**

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Editor's Note: For the purposes of this article, SOP, FAS, and FIN references do not reflect FASB's new codification system promulgated in July 2009.



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