The Basics of Construction Accounting

An Introduction to Construction Accounting & Financial Management Principles

Day 3

Special Thanks to...

Gordon Marshall, Faith McDermott, Mary Davolt, Jill Stone and Tony Stagliano

We are grateful for their time, talent, and diligence in the creating and updating of this course and materials.

It is because of the dedication of our volunteer members that CFMA continues to be The Source & Resource for Construction Financial Excellence.

Questions concerning content, etc. should be directed to education@cfma.org.
Acknowledgement

CFMA would like to acknowledge...

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Program Schedule

- Day 1: Thursday, Nov. 14, 2013 - 3:00-5:00 PM EST
- Day 2: Monday, Nov. 25, 2013 - 3:00-5:00 PM EST
- Day 3: Thursday, Dec. 5, 2013 - 3:00-5:00 PM EST
- Day 4: Thursday, Dec. 12, 2013 - 3:00-5:00 PM EST

Session Presenters

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Today’s Agenda: Day 3

- Section 6 - Computing Earned Revenue
- Section 7 - Cost Reporting Analysis
- Section 8 - Elements of Financial Statements

“The Basics”
Section Six:
Computing Earned Revenue

Earned Revenue Topics
- What is Earned Revenue?
- Practice calculation
- A Look at the WIP schedule
- CIEB/BIEC
- How are “loss” jobs treated?
- Impact when gross margin changes at near 100%
What is Earned Revenue?

- That portion of the total contract amount that a company is able to record during a particular accounting period.

Calculating Earned Revenue

CFMA Basic Construction Co., Inc. was awarded a $20,000,000 contract job for which they estimated costs to be $18,000,000. They are projecting gross profit of $2,000,000.

At the end of Year 1, they have costs to date of $4,500,000 and did not expect any changes in the estimated costs.

In Year 2 they received a change order for $100,000 for additional work for the owner. This would have a cost of $80,000. Additionally a subcontractor went bankrupt on the job and liens had to be paid off. This was going to increase the costs of the job by $1,020,000.

Workbook TAB-6

Exercise & Discussion

- Percentage-of-Completion Cost-to-Cost Method
  - Exercise Year 1
  - Exercise Year 2
  - Cumulative effect of change in gross profit?

- Calculating Percentage Complete Exercises
CIEB/BIEC Topics

- Additional Practice calculations
- CIEB/BIEC Analysis
- Which would you prefer on your balance sheet?
- How does net CIEB/BIEC affect cash or line of credit?

Exercise & Discussion Costs in Excess - Asset

- Compute CIEB & record entry
- Discuss examples of what creates a costs in excess position.
- Review example construction WIP
- What’s greatest danger of a CIEB position?

Cost In Excess Scenario

Prepare the entry

CFMA Basic Construction Co., Inc. began work on the office building just awarded.

The lump sum contract incurred some costs by year-end, but the original total estimated cost was not changed from the original estimate.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Contract Value</strong></td>
<td>$20,000,000</td>
</tr>
<tr>
<td><strong>Estimated Costs</strong></td>
<td>$18,000,000</td>
</tr>
<tr>
<td><strong>Estimated Gross Profit</strong></td>
<td>$2,000,000</td>
</tr>
<tr>
<td><strong>Gross Profit %</strong></td>
<td>10%</td>
</tr>
<tr>
<td><strong>Cost to Date</strong></td>
<td>$4,500,000</td>
</tr>
<tr>
<td><strong>Estimated costs to complete</strong></td>
<td>$13,000,000</td>
</tr>
<tr>
<td><strong>Profit to Date</strong></td>
<td>$18,000,000</td>
</tr>
<tr>
<td><strong>Billings to Date</strong></td>
<td>$4,500,000</td>
</tr>
</tbody>
</table>

Calculate the following from the above data:

- Revenue Earned: $5,000,000
- Billings to date: $4,500,000

Prepare the journal entry:

<table>
<thead>
<tr>
<th></th>
<th>Amount Dr or Cr</th>
<th>Debit or Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income account</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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Cost & Est. Earnings in Excess of Billings (analysis)

- Reflects drain on cash flow
- Over-recognized earnings
- Suggests poor billing disciplines
- Increases financial risk

Exercise and Discussion
Billings in Excess - Liability

- Compute BIEC / Record Entry
- Discuss examples of what creates a billings in excess position.
- Review Example Construction WIP to reinforce discussion.
- What’s biggest danger of a BIEC position?

Billings In Excess Scenario
Prepare the entry

CFMA Basic Construction Co., Inc. received a change order for $100,000 for additional work for the owner with added cost of $80,000.

A subcontractor went bankrupt on the job and increased the costs of the job by $1,020,000.

<table>
<thead>
<tr>
<th>Year 2</th>
<th>Contract Value</th>
<th>$20,100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Estimated Costs</td>
<td>$19,100,000</td>
</tr>
<tr>
<td></td>
<td>Estimated Gross Profit</td>
<td>$1,000,000</td>
</tr>
<tr>
<td></td>
<td>Gross Profit %</td>
<td>5%</td>
</tr>
<tr>
<td></td>
<td>Cost to Date</td>
<td>$17,190,000</td>
</tr>
<tr>
<td></td>
<td>Estimated costs to complete</td>
<td>$1,910,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$19,100,000</td>
</tr>
<tr>
<td></td>
<td>Billings to Date</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Calculate the following from the above data:</td>
<td>Revenue Earned</td>
<td>$18,090,000</td>
</tr>
<tr>
<td></td>
<td>Billings to date</td>
<td>$20,000,000</td>
</tr>
<tr>
<td>Prepare the journal entry</td>
<td>Amount &amp; Dr or (Cr)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Asset</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Liability</td>
<td></td>
</tr>
</tbody>
</table>
Workbook TAB-7

- The WIP Schedule

Billings in Excess of Costs and Est. Earnings (analysis)

- Key source of financing
- Management “sandbagging!”
- Suggest smart billing disciplines
- Unrecognized vendor liability-sub
- Decreases risk ?? (on job level)

CIEB/BIEC Question

- Which position would your Financial Advisors most likely want to see on your statements, CIEB or BIEC?
How are “Loss” Jobs Treated?

- When to recognize
- What to recognize
- What to look for

“The Basics”
Section Seven: Cost Reporting Analysis

Cost Reporting Topics

- How does WIP tie to cost reports?
- Why is cost at completion critical?
- Is same cost coding structure used in all types of construction?
- Sample cost reports
“The Basics”
Section Eight: Elements of Financial Statements

Accounting Conceptual Framework

Key Objective
Qualitative Attributes
Elements of Statements
Assumptions
Principles
Constraints

QUALITATIVE CHARACTERISTICS
Relevance
Reliability
Verifiability
Comparability
Consistency

ELEMENTS
Assets, Liabilities, Equity
Revenues/Expenses
Gains/Losses
Owner Invest./Distrib.
Comprehensive Income

ASSUMPTIONS
Economic Entity
Going Concern
Monetary Unit
Periodicity

PRINCIPLES
Historical Cost
Rev. Rec.
Matching
Full Disclosure

CONSTRAINTS
Cost-Benefit
Materiality
Industry Practice
Conservatism

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Basic Financial Statements

- Balance Sheet
- Statement of Income
- Statement of Retained Earnings
- Statement of Cash Flows
- Work-in-Process Schedule?

Supplementary Information

- Not required by GAAP
- Meets needs of various users
- Content and form vary by company
- Should include WIP Schedule

Workbook TABS-8,9

- TAB-8: FASB Accounting Standards Codification
- TAB-9: Financial Statements
End of Section Eight and Day 3

Wrap-Up / Q&A

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Review Question #1
Using Cost to Cost Percentage of Completion, what drives the amount of revenue recognized?

A. Amount of costs incurred to date
B. Amount of billings to date
C. Amounts paid to date
D. Estimated gross profit on project

Review Question #2
If you did work for which you did not receive a change order, how do you account for it?

A. Add the value of the CO and it’s estimated cost into the calculation of POC
B. Do not add anticipated CO, but reflect the additional cost of the work to lower your projected gross profit
C. Carry only the cost of the work to be recovered not impacting the projected gross profit
D. Either b or c is OK
Review Question #3

What is an example of not adhering to full disclosure in your financial statements?

A. Not providing detail of other assets
B. Not including a Completed Contracts schedule
C. Not including a note regarding a change in the composition of project management
D. Not including a note showing the changes in CIEB and BIEC

Thank You For Your Participation!

Don’t forget to join us for the 4th and Final Session on Thursday, Dec. 12, 2013 3:00-5:00 PM EST
Continue the discussion on “The BASICS of Construction Accounting” live on CFMA’s Connection Café!

For questions about this program contact:
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