Laying a Good Foundation
A chart of accounts is like a foundation. Without a good chart of accounts, the information will be subject to misclassification, sufficient detail will not exist to interpret the information correctly, and users will not be able to distinguish profitable from unprofitable operations. Eventually, the financial statements will fail to benefit upper management because they will no longer be meaningful.

When thought of in these terms, it’s easy to see why a well-formatted chart of accounts is so important. And, while there are many components that go into producing a good system of financial reporting, the chart of accounts is one of the most basic. Therefore, it requires some forethought about its design and layout in order to serve your firm well into the future.

So, whether you are in a seasoned company that is considering some refinements to its current chart of accounts, or in a new company...
defining its first chart of accounts, it’s important to begin with the end in mind.

To do that, first discuss with your owners their vision for the business five years down the road. Next, meet with your bonding agent and ask him or her about common mistakes in financial statements; do the same with your banker. Then, design your chart of accounts to both meet the needs of your owners and avoid the common bonding/banking pitfalls.

**The Basics**

Begin with a basic structure similar to the balance sheet and income statement examples shown on the following pages. While these examples are far from inclusive, they give a general idea of the basic structure. (A very simple account number format has been assumed; more detailed formats are discussed later in this article.)

Notice that the universal rules for assigning account numbers apply to contractors. Assets are given account numbers in the 100s, liabilities in the 200s, and so on. But, contractors also have some unique requirements.

**The Unique Needs of the Industry**

Receivables for a contractor are typically not as straightforward as they are for most other commercial entities. So, in creating accounts for receivables, determine the level of detail you will need. At a minimum, you should have accounts for amounts currently billed, retainage, and allowance for uncollectible accounts.

The allowance account is a *contra* account, which means it should always carry a credit balance or be zero. You may want other accounts for billed claims or billings on unsigned change orders. By setting these amounts in separate accounts, management is able to gain a better feel for receivables likely to be collected in the near-term, compared to those that may be a little more difficult to collect.

Additionally, a *non-current retainage receivable* account should be set up to hold retainage amounts not expected to be collected within the next year.

Costs and earnings in excess of billings represents the total underbilled amounts on contracts at the end of the period. Similarly, *billings in excess of costs and earnings* represents the total overbilled amounts on contracts. This amount is often determined based on a calculation that compares cost incurred-to-date with total contract costs.

The *unbilled receivables* account is similar to cost and earnings in excess of billings, except it may be used to track costs that do not fit well into that category. In particular, pure unit-price work might be better classified as an unbilled receivable.

**Pre-contract costs** are the costs incurred prior to contract commencement (but after the award of the contract) that are accumulated until work begins. These might include the costs for plans and specifications, bonds, engineering services, etc. *Stored materials* typically represent uninstalled materials that are maintained at the jobsite.

Your accounting software package will significantly influence how your chart of accounts is formatted. Accordingly, if you are starting from scratch, look for an account format structure that will support your needs.

**The Next Step**

The relative complexity of your operations will help govern the account structure you choose. For example, a company with multiple divisions will, at a minimum, need a two-part account number. The prefix may identify the division, while the suffix may identify the actual account.

**Creating a Divisional Chart of Accounts**

If you are in the process of making the transition from a simple chart of accounts to one with more than one division, consider the following approach.

First, decide whether you want divisional balance sheets or simply divisional income statements. Probably the most important factor affecting this decision is whether there is one office or multiple locations. For a company with multiple locations, divisional balance sheets may be helpful, particularly if these locations are treated as independent operating units.

Notwithstanding this fact, some items may still need to be allocated somewhat subjectively. Examples of such items include line-of-credit balances, income taxes payable/refundable, and accruals for contingencies. For a company with only one office, a single balance sheet with divisional income statements is probably the best approach.

In creating divisional income statements, all revenue and contract cost accounts will essentially be duplicated for each division. Within the existing accounts, certain accounts may need to be renamed and a few accounts may need to be modified.
In addition to operating divisions, the company would also need to create an administrative or corporate office division. This division would accumulate all operating expenses that are separate from contract costs, as well as other income and expense components.

Some companies have taken the approach that the divisional income statements will end with the gross profit line, and the SG&A expense items will remain within the administrative division. However, the preferred practice is to allocate all expenses from the administrative division to the operating divisions. If your company chooses to follow this practice, management must first decide exactly how the costs will be allocated.

While revenues may be a key factor in determining the allocation of some of these expenses, there are others that are not a function of revenue and, as such, would not logically be allocated on such a measure. In these cases, company management should decide on the most meaningful measure for allocation. (For more information on allocating costs, see “What Is Job Cost?” by Keith R. Fetridge in this issue, and my article, “How to Allocate Overhead,” in the November/December 1999 issue of this magazine.)

Once you have decided on a measure for allocating the different components of administrative expense, you will need to develop a template for calculating the allocation each month. The results of these calculations will be recorded using intercompany entries.

New accounts will be set up to record these entries. A credit will be posted by the administrative division to an account named, for example, **administrative expense allocation out**. This credit will be in an amount equal to the recorded expense total. Likewise, a debit will be posted to each division to an account named, for example, **allocated administrative overhead charge**.

If there are any expenses originally recorded in one division that should be allocated to other divisions, reclassifying entries can simply be posted to the actual expense accounts affected (for example, rent).

**How Much Is Too Much?**

While it may be obvious to one company how it wants to subdivide its information, it may not be so obvious to others, especially when first implementing divisions. The usual rule is the fewer operating divisions, the better.

While you want to build a framework that accommodates growth, you don’t necessarily need to maximize its potential in the first year. For that reason, you may want to begin with two or three divisions; you can consider adding others later.
If you are changing to divisions, consider revising the format of your job numbers in your job cost system to make it easy to identify which jobs belong in which division.

In deciding how you want to divide the operations, consider the following:

- Distinct operating units
- Different locations
- Geographic territories
- Substantially different job types (such as private vs. government contracts)
- The jobs themselves (if the number of jobs is small)

The practice of establishing divisions for each major contract is reasonable as long as the number of very high-volume jobs is small; when this is not the case, structuring divisions for this purpose will prove to be more of a nuisance than a help.

Contractors with few high-volume jobs that wish to set up divisions for each job will need to create contra accounts to offset the amount of prior-year revenue and expense recorded for the job. It is important to discuss this approach with your software vendor to determine how to handle this practice from a systems’ standpoint (for example, traditional year-end closings would have to be modified).

Creating an Equipment Cost Center

Again, if you are expanding from a simple account format to a more detailed chart of accounts structure, you will probably want to consider placing equipment in its own division. Do this by setting up an additional divisional income statement to capture all equipment costs (as shown here in the income statement example).

This division’s revenue would be called *internal equipment rental income* and would be offset by accounts within the “Cost of Contract Revenues Earned” section of the income statement called *internal equipment rental expense*. Entries to these accounts would be made based on predetermined rental rates set by management and then reported on field reports or timecards.

Three- and Four-Part Account Numbers

Up to this point, all of the concepts discussed above could be accomplished using two-part account numbers. However, most mid-range accounting packages now offer at least three-part account numbers or some alternative tracking field within the account setup itself. Taking advantage of such a structure can prove to be beneficial. Some potential uses of a three-part structure are shown below:

<table>
<thead>
<tr>
<th>PART ONE</th>
<th>PART TWO</th>
<th>PART THREE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Location</td>
<td>Division</td>
<td>Account Identifier</td>
</tr>
<tr>
<td>Division</td>
<td>Crew</td>
<td>Account Identifier</td>
</tr>
<tr>
<td>Division</td>
<td>Job Type (fixed, cost+, etc.)</td>
<td>Account Identifier</td>
</tr>
<tr>
<td>Division</td>
<td>Job (small #/high volume)</td>
<td>Account Identifier</td>
</tr>
</tbody>
</table>

Some accounting packages may have the capability of sorting and reporting the information in a variety of fashions. For those that do not, a good report-writer program can develop reports that sort the information into different formats and consolidate activity based on specific criteria.

Here’s another plus: A four-part account number can take the information one level deeper (for example, a location-division-
job/type-account identifier) or it may be used to distinguish between two different entities in the system (for example, to accommodate joint venture accounting).

**When to Transition Your Chart of Accounts**

For an existing business, the transition should take place at year-end to avoid as many potential difficulties as possible. It is vital that you work with your software vendor to accomplish this transition. Your vendor should be able to point out potential pitfalls that could make the transition more troublesome than necessary. (For more information on software considerations, see the “Computers in Construction: Software Selection,” by Mark Dexter and “What’s New for CFMs in Financial Reporting Software” by Christian R. Burger in the January/February 2003 issue of this magazine.)

**Conclusion**

Whether your company is just getting started or has been around for several years, it is helpful to sit back and determine whether the present/planned chart of accounts is a benefit or a drawback to providing management with useful information. Likewise, it is important to have a chart of accounts that anticipates the future growth of your company and allows a structure to accommodate that growth. If either of these elements is lacking, it is a good time to begin planning a transition to a new chart of accounts that will produce significantly greater benefits.

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