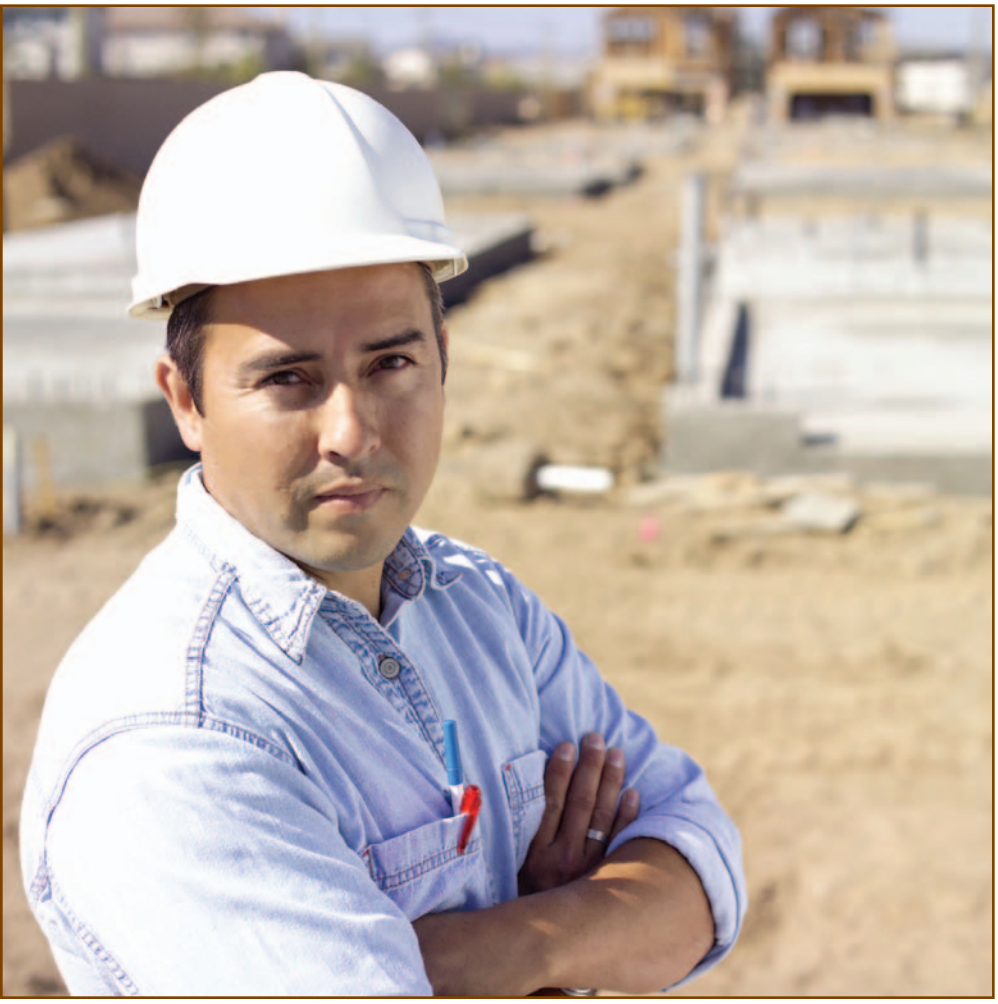
Construction

Industry Advisor

Fall 2010



Revenue recognition

Proposed changes mean big impact on contractors

Go on the defense with an escalation clause

Bonding: Subprime is *not* a dirty word

Contractor's Toolbox

Want to improve your financial performance?
Track the WIP!

Revenue recognition

Proposed changes mean big impact on contractors

As if the slow economy isn't causing you enough problems, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published a joint exposure draft on revenue recognition that could give you more trouble. The boards are proposing a new standard, entitled *Revenue from Contracts with Customers*, that would have significant implications for construction firms. Here's a look at how revenue recognition works now and how it could look in the future.

How it works now

Under current standards, there are two generally accepted methods of accounting for long-term construction contracts:

1. The percentage-of-completion method (PCM), under which revenue and expense are recognized ratably over the course of a contract (based on some reliable measure of progress, usually costs incurred), and
2. The completed contract method, under which revenue and expense aren't recognized until the project is substantially complete.

Most contractors prefer PCM because, during a project, it provides a more accurate financial-performance picture for bonding companies and lenders.

Suppose, for example, that a contractor is hired to construct a building over two years for $2 million and that the estimated cost is $1.8 million. At the end of Year 1, the contractor has incurred $900,000 in costs, which means the project is 50% complete. Under PCM, it recognizes 50% of the contract price, or $1 million, in Year 1, for a first-year profit of $100,000. Under the completed contract method, however, it won't report any profit on the job until it's completed in Year 2.

Don't panic, yet

The new accounting standard could have a major impact on contractors because it would eliminate PCM for long-term contracts. But there's no reason to panic: The proposed standard would allow you to achieve accounting results similar to PCM for many projects. Determining whether this treatment is appropriate, however, would require careful analysis.

Also keep in mind that the proposal deals with use of PCM for *financial reporting* purposes. Different rules apply to use of PCM for *tax* purposes. (See "SBJA adds a new twist to PCM treatment" on page 3 for a recent tax-related PCM development.)

A new principle

The boards' proposal is designed to establish uniform standards for revenue recognition. To

that end, it introduces a new core principle: Companies should recognize revenue only from the transfer of goods or services to a customer.

Revenue under a contract (or a group of related contracts) would be recognized when distinct "performance obligations" are satisfied. The exposure draft outlines a five-step process for applying the new rules:

1. Identify the contract (or contracts).
2. Identify separate performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to separate performance obligations.
5. Recognize revenue when a performance obligation is satisfied.

For construction firms, Steps 2 and 5 would present the biggest challenges.

Identifying your performance obligations

A performance obligation is simply an agreement to provide a good or service to a customer. Under the proposal, contract items are accounted for as separate performance obligations if they're "distinct."

That means that either 1) the contractor (or other company) sells similar goods or services separately, or 2) the contractor could sell the good or service separately because it has a *distinct function* and a *distinct profit margin*. Identifying performance obligations within a construction project and allocating the contract price among them requires considerable analysis and judgment.

No two construction projects are exactly alike, but the exposure draft provides an example that involves a construction project that calls for design, procurement and construction activities. According to the exposure draft, design is a distinct performance obligation because similar services are sold separately by the contractor and its competitors. Site preparation and site finishing are also separate performance obligations because they involve "distinct risks."

But the remaining activities — including contract management and procurement — are "highly interrelated" and, therefore, are accounted for as a single performance obligation.

Recognizing revenue

Another challenge you'd face under the proposed standard is determining when a performance obligation has been satisfied, thus triggering revenue recognition for the allocable portion of the contract price. According to the exposure draft, a company satisfies a performance obligation when it transfers the promised good or service to the customer, which means that the customer "obtains control" of the good or service.

Indicators that a customer has obtained control include the following:

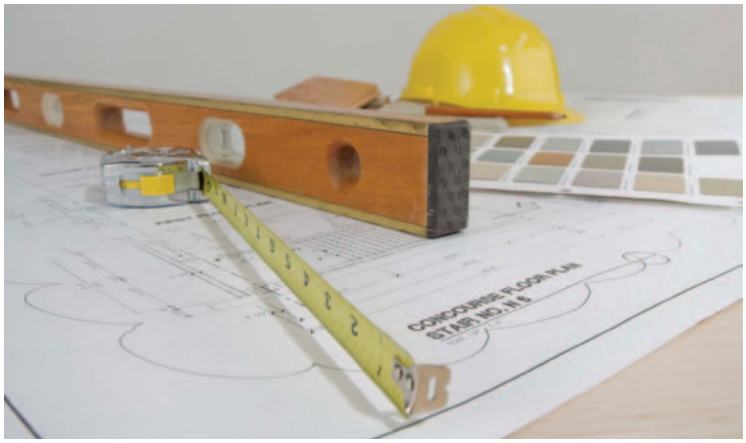
- The customer has legal title,
- The customer has physical possession,
- The customer has an unconditional obligation to pay, and
- The design or function is customer-specific.

SBJA adds a new twist to PCM treatment

In September, Congress enacted the Small Business Jobs Act of 2010 (SBJA), which includes a tax provision extending 50% bonus depreciation to 2010. Making this break even more attractive to contractors, SBJA also allows contractors to allocate the cost of qualified property to a contract as if bonus depreciation had *not* been enacted.

What does this mean to calendar-year taxpayers? If you're required to use the percentage-of-completion (PCM) method for tax purposes to account for a long-term contract in 2010 and you purchase and place into service equipment that has a cost basis of $500,000 and a Modified Accelerated Cost Recovery System (MACRS) recovery period of five years, the depreciation on the equipment can be taken into account as a cost allocated to the contract for 2010.

Bottom line? You could deduct on your 2010 tax return a whopping $300,000 for that piece of equipment.



The exposure draft contemplates situations involving a "continuous transfer of goods or services." Under those circumstances, you can recognize revenue ratably over the course of a particular performance obligation based on a suitable measure, such as units produced, milestones reached, or labor hours or costs incurred.

As you can see, this approach is similar to PCM, though it applies separately to each performance obligation rather than to the contract as a whole. Whether a project qualifies for "continuous transfer" treatment depends on several factors, including the nature of the project, the contract terms and local property laws.

Ratable recognition of revenue may be available, for example, when a contractor builds a project on an owner's land and receives nonrefundable progress payments. But if a contractor acts as a developer or if the owner can recover progress payments if specifications aren't met, the contractor may not be able to recognize revenue until a performance obligation has been completed.

In addition to new revenue recognition rules, the proposed standard would allow capitalization (rather than expensing) of certain mobilization and other upfront costs to avoid negative profit margins during the early stages of a project. It would also provide guidance on accruing anticipated losses and require additional financial statement disclosures.

Next steps

FASB and IASB expect to publish their final standard by June 2011, though it's not yet certain when the standard will take effect. In the meantime, work with your CPA to assess the potential impact of the new rules on your financial statements and, if appropriate, consider changes to your contracts, accounting systems and estimating procedures. ■

Go on the defense with an escalation clause

Contractors everywhere have experienced the pain of rising construction materials costs and less work, putting their businesses in financial jeopardy. How can you fight back? Include an escalation clause in your job contracts.

How does it work?

Without getting into too much legalese, an escalation clause specifies that, in the event materials costs rise beyond a specified amount, you may pass those costs along to the project owner.

For many years, such clauses have been fairly common in larger, long-term jobs. But as materials costs have risen, contractors have started adding escalation clauses to virtually any size contract — from single-family homes to commercial high-rises to mixed-use developments.

What's driving up the price of construction materials nowadays? Many blame a building boom overseas, particularly in China. Others point to environmental reasons — loss of forestlands

driving up lumber prices, for instance. And, of course, transporting materials is always an issue because of fluctuating fuel costs. For all those reasons, an escalation clause is especially important.

To make it through contract negotiations — and to increase the likelihood of its being upheld in court should litigation arise — an escalation clause must clearly define the materials in question and specify the "triggering event" that activates the clause. A typical triggering event is a 2% or 3% rise in the originally estimated materials cost.

An escalation clause must clearly define the materials in question and specify the "triggering event" that activates the clause.

Moreover, the U.S. Department of Labor (DOL) Bureau of Labor Statistics notes in its PPI Program Spotlight No. 98-1 that "an escalation clause should specify whether price adjustments are to be made at fixed intervals, such as quarterly, semi-annually or annually, or only at the expiration of the contract."

Perhaps most important, though, is that the clause describe the method used to calculate the escalation.

How is the escalation calculated?

Several methods are commonly used when setting the escalation. The simplest is the "invoice" method, in which you use a supplier invoice or other like document to substantiate a materials price change.

You might also use a widely accepted, published price index to support your claim. Such indexes are typically available for materials such as lumber, cement and steel. However, the DOL warns that any given index might not be available for a particular time period, because either price information wasn't supplied by enough survey respondents to meet publication standards, or the index was discontinued due to a decline in the commodity's importance in the marketplace. It's also possible that any particular index won't accurately account for localized cost variations.

A third option is a hybrid approach. Under one such approach, the triggering event is specified as an increase under both the invoice method and the index method. Under another hybrid approach, the invoice method is subject to a limit based on a widely accepted index.

In any case, the rationale behind these hybrid approaches is to provide a sort of check and balance on invoices by ensuring that the supplier's prices aren't widely different from market prices. Work with your CPA to determine an accurate method of calculating any materials price escalations.

What are the risks?

Perhaps the biggest risk of an escalation clause is that its inclusion in the contract will stall negotiations or quash the project entirely. The right contract language, as well as full disclosure and

open discussion of the matter, however, can go a long way toward assuaging any owner fears about the clause.

Another risk is mishandling a claim should one arise. If you decide to take the plunge and write an escalation clause into a contract, be sure to document your materials acquisitions and costs carefully.

What's the bottom line?

Despite the recession, the rising cost of building materials is still an issue. If you don't take steps to contain those costs — via an escalation clause — your construction firm may suffer financial repercussions. Because such clauses are part of contract law, make sure you work with a qualified attorney when developing the contract. ■

Bonding: Subprime is *not* a dirty word

The term "subprime" has had a bad rap, and with good reason. After all, it's associated with predatory lending practices that have had a lot to do with the current financial crisis in the United States.

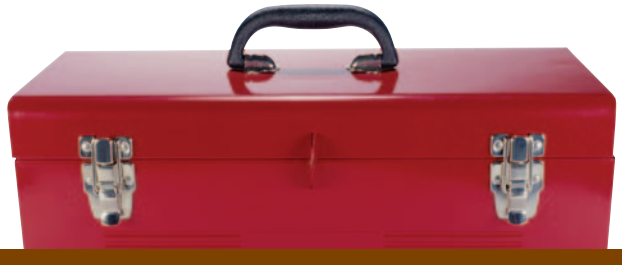
But subprime lending isn't bad by definition; it simply means extending credit to less qualified borrowers, who pay a higher interest rate to compensate the lender for its increased risk. And it isn't new — historically, most financial and insurance products have had some sort of subprime market.

In construction, subprime bonding works essentially the same way as traditional bonding. Performance bonds, payment bonds and other products are available either by the job or as part of a bonding program. The key difference is that subprime sureties charge higher rates (often double those charged for traditional bonds) to cover the additional risk.

In addition, subprime sureties usually demand personal guarantees from the owners as well as collateral, which may have to be in cash. For a particularly risky contractor, the surety may also require the use of an escrow agent to receive project payments, pay subcontractors and meet payroll.

Naturally, subprime bonding shouldn't be your first choice. But in the construction industry, access to bonding can be critical to a firm's survival. And subprime bonding offers a viable option for contractors that don't qualify for traditional bonding in today's tight market. Subprime bonding may also be appropriate for contactors that are entering new geographical markets, tackling new types of work or bidding on larger projects in order to stay competitive.

Before you pursue subprime bonding, consult your advisors to be sure you understand the risks and structure the best deal possible.



Want to improve your financial performance?

Track the WIP!

Even in the best of times, construction is an uncertain business. When the economy is struggling, this uncertainty is magnified. To avoid unpleasant surprises, continually monitor your work-in-progress (WIP).

Why WIP?

Using a WIP report, you can track key information about each project, such as contract price (including approved changes), projected final costs, costs incurred and amounts billed to date, estimated gross profits (with and without approved changes), and the value of pending changes.

Timely, accurate WIP reports can also help you identify problems early in a project, giving you an opportunity to investigate and address the causes before they become unmanageable.

Profit fade

One problem WIP reports can uncover is "profit fade," the phenomenon in which a project's projected gross profits gradually decline over time. It can be caused by many things, including inaccurate estimates, lax project management or unexpected jobsite problems.

Widespread profit fade can hurt your financial performance and reduce your bonding capacity, so staying on top of it is critical. If your WIP reports indicate profit fade, review your estimating procedures, consider being more conservative with your estimates and take a closer look at your project management practices.

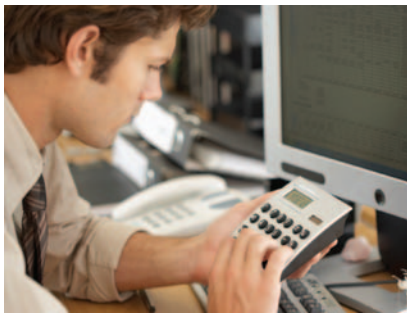
Underbilling

WIP reports also can uncover billings that lag behind a job's progress, which can hurt your bonding capacity and lead to cash-flow problems. If your WIP report indicates such "underbilling," investigate the underlying reasons for it.

Underbilling may signal a problem that needs to be corrected. Or it may simply reflect a large number of unapproved change orders or the existence of front-loaded costs that will be recovered later in the project.

Bonding and profitability

WIP reports are also invaluable to your bonding relationships. They allow you to spot trends early, enabling you to alert sureties to any potential problems and explain your strategies for addressing them. They also provide ammunition to address any unusual items that may worry your surety, such as underbillings caused by legitimate business practices.



Finally, by sorting WIP information by categories, such as job type, location, customer, contract size, project manager or estimator, you can gain valuable insight into the factors that affect your firm's profitability.

WIP into shape

There are many ways to prepare WIP reports, including pencil and paper, Excel spreadsheets, your accounting system or some other software solution. Whichever method you use, the reports will be of little value unless they contain relevant, timely and accurate information and are reviewed by management regularly. ■