Chapter 1

NATURE AND SIGNIFICANCE OF THE CONSTRUCTION INDUSTRY

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Identify common participants in the construction industry.
- Recall the four basic types of construction contracts.
- Identify the role of the surety in the construction process.
- Recall the basics of contract accounting.

Types of Contractors

The definition of a contractor is very broad. It is important that any adviser understands the general makeup of the industry. Different types of contractors have different risks and service needs. Construction contractors can be classified based on their size, the type of construction activity they undertake, and the nature and scope of their responsibility for the construction project. As a first step toward servicing your construction clients, you should understand how they fit into the summary in exhibit 1-1.

Exhibit 1-1 Types of Contractors

Contractor Type	Nature and Scope of Work
Design-build	Also known as a "turnkey" contractor, they specialize in heavy construction such as power plants, refineries, and hydroelectric facilities. A design-build project requires extensive management skill, including the ability to manage projects over a wide geographical area. A design-build contractor manages all phases of the project, from the feasibility study through the final construction.
Heavy Construction	May build roads, bridges, dams, airports, or large buildings. Typically, the work is performed for public agencies or large corporations that do their own designing and engineering.
General Contractors	Prime contractor who enters into a contract with the owner and who takes full responsibility for its completion. May engage subcontractors to perform specific parts or phases of projects. Specialties may include housing, schools, hospitals, office buildings, manufacturing plants, or warehouses.
Subcontractors	A second-level contractor who enters into a contract with the general contractor to perform a specific part or phase of a project. Specialties may include electrical, plumbing, concrete, mechanical (including heating and air conditioning) carpentry, drywall, and flooring.
Construction Manager	Enters into an agency contract with the owner to supervise and coordinate the construction activity on the project, including negotiating contracts with others for the work. The distinction between a construction contractor and a construction manager is important for tax purposes.

Players in the Industry

Just as it is important for us to understand the type of contractor we are dealing with, it is also important that we understand whom the contractor is dealing with. This understanding should play a major role in determining client acceptance criteria and who may be affected by the advice we have given to our client:

- *Project owner* – Who are the parties that our client serves?
- *Architect and engineer* – Where are the plans coming from? What is the reputation? Who is approving our application for payments?
- *Other contractors* – What type of subcontractors do we use? What is the capacity of the subcontractors being used? Are the subcontractors bonded?
- *Surety* – What does the surety look at? What is the reputation of the surety? What is the contractor's reputation with the surety?
- *Bond agent* – What is the contractor's relationship with our bonding agent? What avenues of bonding does the agent provide?
- *Lawyer* – What experience does the contractor's lawyer have with construction law? Experience with labor law?
- *Banker* – Who is loaning the funds for the contractor's project? What agreements does our client have in place to fund his cash flows?

PLAYERS WITHIN THE CONTRACTOR CLIENT

- *Owners of the company* – What is their character? What is their reputation? What is their attitude?
- *Controller and bookkeeper* – What is their experience? What is their skill? How reliable are they in providing information?
- *Estimators* – What is their experience? What is their ability? How effective are they?
- *Project managers* – What is their experience? What is their capacity?
- *Labor force* – Is the labor force unionized? What is the skill?

Types of Contracts

Not only are there many types of contractors and players in the construction industry, there are also many types of construction contracts. The type of contract is very important to the contractor and CPA alike. From the contractor's point of view, there are advantages and disadvantages to all types of contracts. From the CPA's point of view, the different types of contracts may lead to different ways of looking at a contract to properly recognize revenues. There are four basic types of contracts:

- Fixed fee or lump sum – This contract is one in which the price is not usually subject to adjustment because of the costs incurred by the contractor. Owners prefer fixed-price contracts because they feel it limits their exposure due to the contractor's cost overruns. The disadvantage to the owner is the length of time it takes to complete a fixed-price contract. The delay is due to the finalizing of plans and the process of seeking competitive bids.
- Time and material – Time and material contracts generally provide for payments to the contractor on the basis of direct labor at fixed hourly rates. These rates are adjusted by the contractor's added overhead and indirect costs. The charges to the owner also include materials with certain markup in pricing.
- Cost plus – Cost plus contracts provide for reimbursement of allowable costs plus a fee as defined by the contract. The purpose for using the cost plus contract is due to the essence of time at hand for completion. This is the fastest and typically more costly of contracts for a project owner.
- Unit price – Unit price contracts are those contracts under which the contractor is paid a specified amount for every unit of work performed. It is very similar to a fixed-fee contract, but it varies if the number of units required differs from the engineer's report of bid package. Contracts are usually awarded based on the total of the unit prices applied to the units supplied in the bid package. The method of determining the contract price will vary, as the bidding contractors will compete on different pricing and structural strategies.

The Role of the Surety

Most contracts entered into have some form of bonding requirements. These bonding requirements assure the project owner that the project taken on by the bonded contractor will be completed for the price the contract was bid at by the contractor and accepted by the project owner. The bond is secured by an entity called a surety. The surety makes decisions about the contractor based on the contractor's character, capacity, and capital.

The surety industry has learned some tough lessons in the construction industry. The surety industry is scrutinizing and screening clients more now than they ever have. It is important that the CPA be aware of this, as much of the surety's evaluation come as a result of the financial statements.

Contractors will be asked to document their financial stability and profitability, as well as their ability to meet current and future obligations. To meet more detailed underwriting, contractors may be expected to provide the following information:

- Independently audited financial statements within 90–120 days
- Interim financial statements
- Aging of accounts receivable and payable
- Analysis of overhead costs
- Equipment schedules
- Profit and loss statements
- Outline of complete bank agreements (line of credit, turnaround to collect, and so on)
- Up-to-date work-on-hand reports Comprehensive business plan, forecast, or strategy (both short-term and long-term)
- Resumes of key employees and management
- Personal and corporate indemnity

CPAs should be aware of these requirements and can be of great assistance for the small contractor in providing the information for the surety. The more upfront the contractor is with the surety, the better the relationship between the surety and the contractor. The better the relationship between the contractor and surety, the better the odds the contractor has at increasing his or her bond program.

When a surety evaluates a contractor, the surety looks for certain warning signs in order to minimize the surety's risk. Some of the risks and warnings signs for sureties are as follows:

- The contractor's accounting and financial reporting system – The surety likes receiving timely information from the contractor. The contractor's inability to produce standard financial statements and job profit or loss reports is not a strong sign for the surety.
- Turnover of personnel – The leadership of the contractor is crucial. A contractor's experience and capacity within the industry relieves the surety of certain concerns. An important consideration regarding the leadership is the contractor's successor in the event of death or disability. A plan of succession is important.
- Changes in the contractor's business – The change may be dealing with the type of construction engaged in by the contractor or it could be dealing with the size of the contracts the contractor is pursuing.
- Maximized lines of credit – This warning sign informs the surety that the contractor has nowhere else to go in the event of problems on the job. The risk of filing claims only increases that much more.
- Poor estimating and project management – The evidence of varying bid spreads of significant degrees concerns the surety that the contractor's estimating department is inexperienced or proves their lack of ability. A continual downward trend of profit fade on jobs and diminishing gross margins is of concern especially if the contractor does not have a contingency plan on improvement or the contractor lacks the balance sheet strength to overcome the negative trends.

KNOWLEDGE CHECK

1. When a surety is evaluating a contractor, what is the surety more concerned with?

   a. The contractor's financial institution.
   b. The contractor's accountant.
   c. The contractor's accounting and financial reporting system.
   d. The contractor's management.

Contract Accounting

On May 28, 2014, FASB and the International Accounting Standards Board issued joint Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers (Topic 606)*, on revenue recognition to address a number of concerns regarding the complexity and lack of consistency surrounding the accounting for revenue transactions. FASB ASU No. 2014-09 is effective (as amended by FASB ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606)—Deferral of the Effective Date*), for contractors classified as public business entities, for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period.

For contractors not classified as public business entities, ASU No. 2014-09 is effective for annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. These contractors may elect to adopt the standard earlier, however, only as of either

- an annual reporting period beginning after December 15, 2016, including interim periods within that reporting period, or
- an annual reporting period beginning after December 15, 2016, and interim periods within annual periods beginning one year after the annual reporting period in which an entity first applies

ASU No. 2014-09 provides a framework for revenue recognition and supersedes or amends several of the revenue recognition requirements in FASB ASC 605, Revenue Recognition, as well as guidance within the 900 series of industry-specific topics, including FASB ASC 910, *Contractors—Construction*. The standard applies to any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance or lease contracts).

Readers are encouraged to consult the full text of this ASU on FASB's website at www.fasb.org.

The AICPA will provide a more detailed overview of this change to the accounting for construction contracts and contractors in future revisions of this course. Appendix A is a summary of the new accounting for revenue from contracts with customers as provided for in ASU No. 2014-09.

The authoritative literature on accounting for construction contracts is Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35. Note that the AICPA Audit and Accounting Guide, *Construction Contractors* is an additional useful tool to the CPA.

The most important issues that a contractor faces are the recognition and measurement of revenues and costs for uncompleted contracts. This is the more complicated area for both the accounting and audit of a contractor.

The accounting for a contract involves the following three steps:

1. Determine the profit center (that is, the contract).
2. Determine which accounting method is appropriate for the contract (percentage of completion or completed contract).
3. Apply the appropriate accounting method.

In accounting for the contract, two methods are the most common in reporting uncompleted contracts under FASB ASC 605-35:

- Percentage of completion
- Completed contract

PERCENTAGE OF COMPLETION

The use of percentage of completion is highly dependent on the ability of the contractor to make estimates. The percentage of completion method should be used in all instances where reasonably dependable estimates can be made and all of the following conditions exist:

- Contracts executed by the parties normally include provisions that clearly specify the enforceable right regarding goods or services to be provided and received by the parties, the consideration to be exchanged, and the manner and terms of settlement.
- The buyer can be expected to satisfy its obligation under the contract.
- The contractor can be expected to perform its contractual obligation.

The percentage of completion formula is as follows:

(Estimated Total Contract Price – Estimated Total Contract Costs) × Estimated Completion %
= Estimated Gross Profit to Date

COMPLETED CONTRACT

The completed contract method should be used when persuasive evidence overcomes the presumption that the contractor should use the percentage of completion method. In other words, the completed contract method is used when the contractor cannot estimate costs as a single amount, range, or loss. The completed contract may also be used when the completed contract method does not differ materially from the percentage of completion method. This may be the case for contracts that can be completed in a short time span.

Practice Pointer

The use of anything other than the percentage of completion method on the financial statements of a contractor will cause concern for the surety. The inability of a contractor to make estimates regarding the contracts entered into may imply to the surety that the contractor does not understand his or her business. This is especially the case when the contracts treated under the completed contract method are those being bonded by the surety.

KNOWLEDGE CHECKS

2. What is an appropriate method for reporting uncompleted contracts under FASB ASC 605-35?

   a. Percentage of completion method.
   b. Cash method.
   c. Straight accrual.
   d. Uncompleted contracts are not reported under FASB ASC 605-35.

3. When calculating the percentage of completion, what are the most important components?

   a. Billings.
   b. Estimates.
   c. Backlog.
   d. Unused materials.

Additional Resources for the Construction Industry

The construction industry is full of associations for both the contractor and the accountant who serves the construction industry. Some of these resources are as follows:

- Surety Information Office (SIO) is the information source for contract surety bonds in public and private construction. SIO provides free brochures, CDs and PowerPoint presentations about surety bonding to construction project owners, lenders, contractors, and design professionals.
- Associations
- Construction Financial Management Association (CFMA)
- Associated General Contractors of America (AGC)
- Associated Builders and Contractors (ABC)
- Construction Industry CPAs and Consultants Association (CICPAC)
- Practice Development Institute (PDI)

Summary

This course was designed to add to the basic understanding obtained in the prerequisite course offered by the AICPA. The construction industry is alive and well and relies heavily on the advice and expertise of the CPA. The uniqueness of the construction industry requires the CPA to gain a thorough understanding of the industry and additional tools in order to advise their contractor client to survive in this tough industry. The CPA's lack of understanding could result in a contractor's failure and a surety's losses.

