Construction

Industry Advisor

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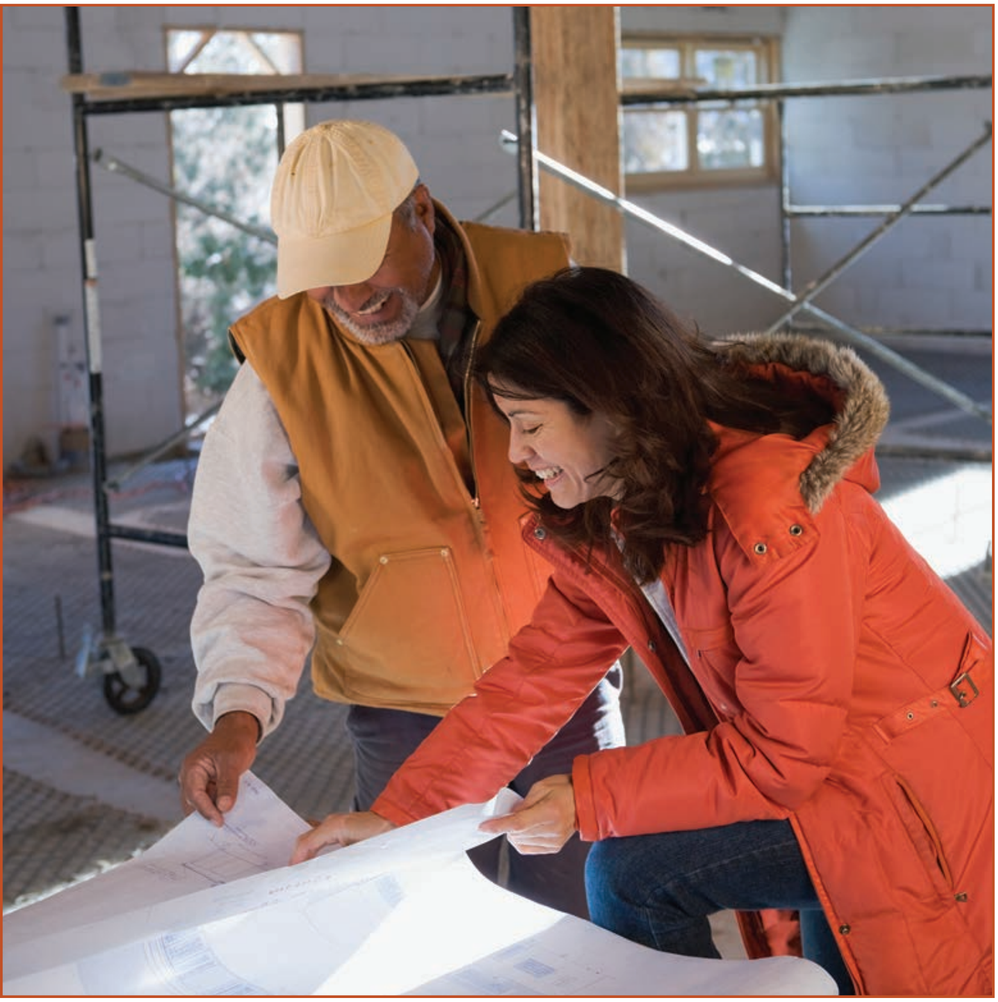
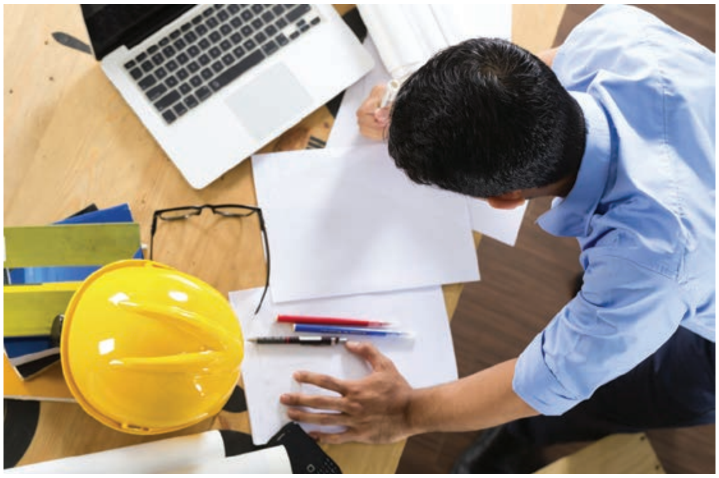


New accounting standard may affect your revenue recognition



Recently, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a new, converged revenue recognition standard, concluding a multiyear effort to develop uniform, worldwide guidelines. By replacing industry-specific rules, the new standard strives to eliminate inconsistencies and improve financial statement comparability.

How will this affect your construction business? For most construction contracts, applying the new standard will produce revenue results similar to those under current standards. But for some contracts, the new standard will change the timing of revenue recognition. It will also require management to exercise greater judgment over revenue reporting and to include new financial statement disclosures about the process.

Under the new standard, performance obligations are satisfied, and revenue recognized, when control of a good or service is transferred to the customer.

A new model

The standard outlines a new, five-step model for recognizing revenue:

1. Identify the contract with a customer. In some cases, two or more contracts will be combined into one for financial reporting purposes.
2. Look at the performance obligations. One contract may contain a single performance obligation or several distinct obligations.
3. Determine the transaction price.
4. Allocate the transaction price among the performance obligations.
5. Recognize revenue when (or as) the performance obligations are satisfied.

The model involves considerable judgment on the part of management. For example, suppose a contract includes contingent consideration, such as incentive payments. If management concludes — based on its experience with similar jobs — that it will likely achieve the performance goals, it should include incentive payments in the transaction price.

Performance obligations

These obligations are promises to provide goods or services. Contractors typically treat contracts as a single promise (to construct a building, for example). But under the new standard, businesses will need to analyze their contracts and account for each "distinct" good or service — or bundle of goods or services — as a separate performance obligation.

For example, a promise to build a road and a bridge might be treated as two distinct performance obligations, requiring the contractor to allocate the contract price between the two and recognize revenue from each obligation separately. It's likely, however, that most construction contracts will continue to be treated as single performance obligations. (See "One performance obligation or many?" at right.)

Recognizing revenue over time

Today, contractors often recognize revenue over the life of a job using the percentage-of-completion method. Under the new standard, performance obligations are satisfied, and revenue recognized, when *control* of a good or service is transferred to the customer. This may happen at a point in time (when a contract is completed, for example) or over time.

The rules are complex, but, in general, revenue is recognized over time if the customer gains control of the work as it's performed or if the contractor has no alternative use for the resulting asset and has an enforceable right to payment for work completed to date. Determining whether control has been transferred is a judgment call, but several factors may indicate customer control, including the contractor's right to payment, the customer's legal title to the asset or the customer's possession of the risks and rewards of ownership.

If revenue is recognized over time, there are several ways to measure progress, including output methods (such as surveys or appraisals) and input methods (such as cost-to-cost or labor hours). Often, the results of these methods will be substantially similar to those of the percentage-of-completion method.

Get ready

These are just a few of the areas that will be affected by the new standard. Others include change orders, customer-furnished materials, uninstalled materials, contract costs, claims and warranties.

The new standard doesn't take effect until 2018 (2017 for public companies). Nevertheless, begin preparing now by reviewing your contracts, evaluating the potential impact on your revenue, and considering changes that might produce better revenue results. Also, compliance with the standard may require you to adopt new policies, procedures, systems or controls, so the sooner you start the better. ■

One performance obligation or many?

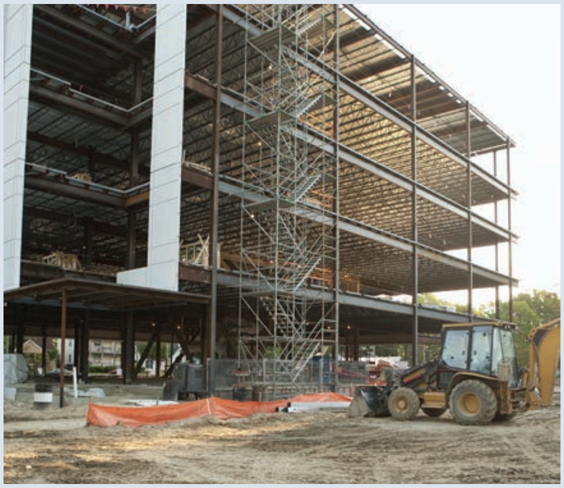
Under the new revenue recognition standard (see main article), a good or service (or bundle of goods or services) is treated as a separate performance obligation if it's "distinct." Generally, this means that:

- The customer can benefit from it (either on its own or together with other readily available resources), and
- It's separately identifiable in the contract.

Under this definition, many construction contracts will continue to be treated as single performance obligations.

One example in the new standard involves a construction business that contracts to build a hospital. The company is responsible for overall management of the project and identifies various goods and services to be provided, including engineering, site clearance, foundation, procurement, building construction, piping and wiring, equipment installation, and finishing.

Although the customer can benefit from these goods and services, they aren't separately identifiable in the contract. Why? Because the company "provides a significant service of integrating the goods and services (the inputs) into the hospital (the combined output) for which the customer has contracted."



Why you should consider performance-based bonuses

To ensure the continued success of your construction business, it's imperative to keep your employees motivated. One way to accomplish that is to offer performance-based bonuses. But, be forewarned: Developing an effective performance-based plan can be a challenge.

The problem with "one-size-fits-all" plans

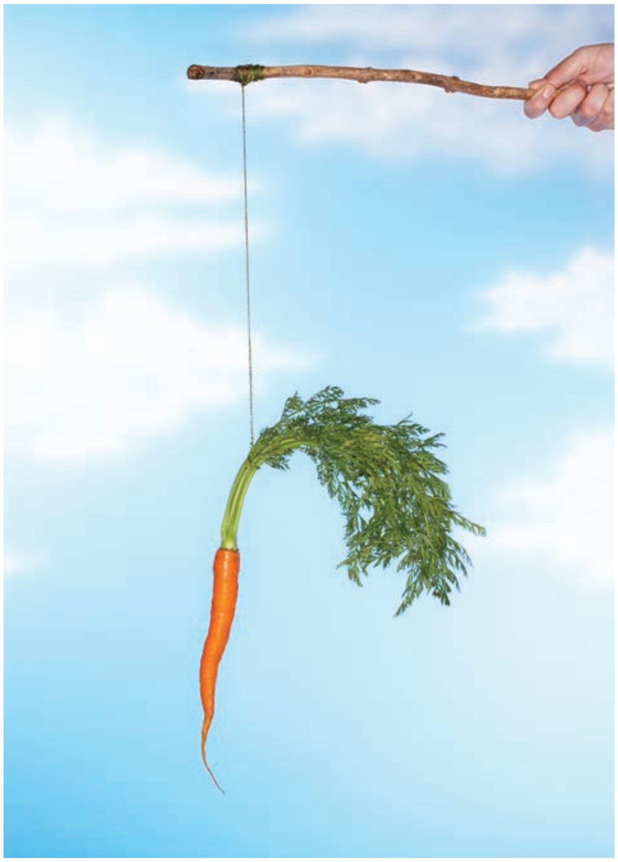
Traditional one-size-fits-all bonuses are predictable, readily understandable and easy to administer. Everyone gets the same amount or percentage, from the staffer who always goes the extra mile to the one who coasts through every day.

Because such bonuses really are nothing more than gifts, they're likely to do little to boost productivity or build loyalty. Plus, many construction companies have done away with them to save money, leaving little to no financial incentive for workers to go the extra mile to, say, push business growth up 15%.

How to motivate employees

If you want to motivate your employees and align their efforts more closely with company goals, consider changing your year end bonus plan (assuming it still exists) to a performance-based bonus plan — or adding such a plan if you don't currently offer bonuses. After all, most employees will be extremely interested in doing what they can to help the company post that aforementioned 15% growth if it will mean reaping some of the rewards in the form of bonuses for themselves.

For your performance-based plan to produce the intended results, you should tie bonuses to specific activities that will lead to company success. The areas you target for improvement will depend on your situation, but they could include faster time to completion, decreased overtime, increased customer satisfaction and reduced expenses or labor hours.



It's critical to communicate with your employees about their eligibility for the bonus pool and indicate that bonuses are discretionary. You don't want to commit yourself to bonuses on a couple of jobs if you have multiple problem projects or a lack of backlog.

Paying for the bonus program

While you're selecting your goals, you'll also need to decide how to pay for the program. Some rewards pay for themselves. If a crew brings a job in with 10% fewer hours than you had bid, for instance, that savings goes straight to your bottom line, and you can give some of it back in the form of bonuses.

Unfortunately, improvements such as a reduction in return-to-work percentage or heightened customer satisfaction don't show up on the balance sheet immediately or directly. Thus, you'll need to set threshold profit levels for the company to meet before bonuses are paid.

Knowing your break-even margin will make it easier to establish thresholds. You reach the break-even margin when your projects generate enough gross profit to cover fixed expenses. Armed with that information, you can determine how much extra margin is available for incentive pay.

Timing and quality

Two other important considerations in developing performance-based reward systems are timing and quality.

If you wait until the end of the year to give bonuses earned in June, the connection between the improvement and the reward could be lost. Instead, consider making your bonus plan pay out quarterly — as long as you make it clear that no bonuses will be awarded unless goals are met each quarter. Alternatively, you might consider a job-based system that awards bonuses on criteria specific to each project.

Emphasize, too, that you won't sacrifice quality or safety. It's all well and good to reward people for doing a job quickly, but if they're cutting hours by cutting corners, they're actually hurting your bottom line. Be sure your bonus plan doesn't encourage savings at the cost of quality or safety. Perhaps the bonus calculation could include some elements tied to safety goals.

A good deal for everyone

Keeping your workforce motivated is key to your bottom line. That's why you should seriously consider developing a performance-based bonus plan. It can be good both for your workers and for you! ■

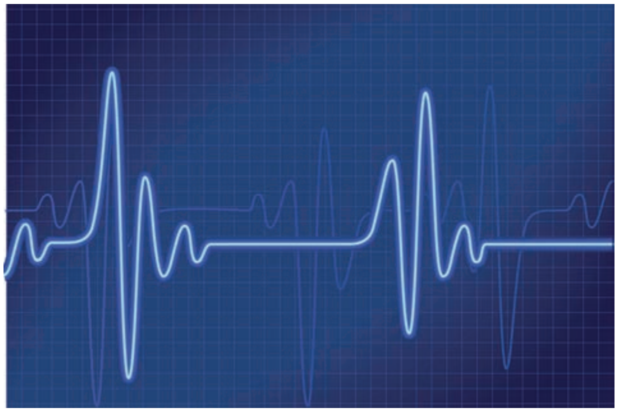
Check your company's financial pulse with a WIP report

After a project is completed, it's useful to perform a "postmortem" to not only analyze what went right and what went wrong, but also apply what you learn to improving performance on future projects. But what about current jobs? Using work-in-process (WIP) reports, you can monitor vital signs while jobs are in progress and then, if needed, look for ways to breathe new life into them.

Analyzing WIP for key indicators

WIP reports track key information about each of your jobs, such as:

- Contract price (including approved change orders and, possibly, unapproved change orders you're confident you'll collect),
- Estimated job costs (including change orders),
- Estimated gross profits (with and without change orders),
- Costs incurred to date (including accrued expenses not yet billed),
- Revenues recognized,
- Percentage of completion,
- Billings to date, and
- Billings to date in excess of revenues earned to date, or vice versa.



Regular WIP reports can help you spot problems and address them before they escalate out of control.

For example, the report may indicate that a job is underbilled — that is, revenues to date exceed billings to date. Underbilling may signal a variety of potential problems, such as management inefficiencies, lax billing practices, cost overruns or a risky number of unapproved change orders. Any of these problems can strain your cash flow or jeopardize your bonding capacity.

Underbilling isn't always a bad sign, though. It may simply reflect significant front-loaded costs that will be recovered gradually over the remainder of the job. But if jobs are underbilled, you should investigate further and ascertain the causes.

Generally, on healthy jobs, you want to see billings to date that equal or exceed revenues to date. But it's a good idea to examine high levels of overbilling. In most cases, overbilling means you're doing a good job managing cash flow. But if overbilling results from some sort of management deficiency — unrecorded costs, for example — it can be a sign of trouble ahead.

Regular WIP reports can help you spot problems and address them before they escalate out of control.

Also, while sureties generally view overbilling as a positive, they'll compare billings on all of your jobs to make sure you're not "job borrowing" — that is, overbilling on some jobs to compensate for shrinking profits on others.

Spotting trends

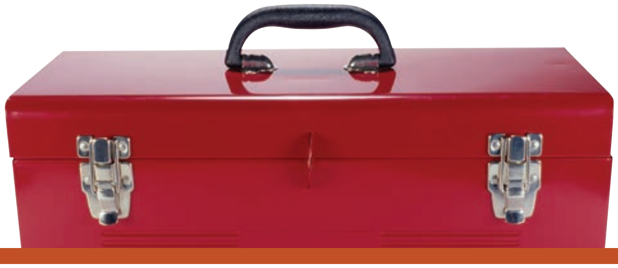
Comparing WIP reports and completed contract schedules over time can reveal dangerous trends, such as "profit fade." As the name suggests, profit fade is a gradual decline in estimated gross profits over the life of a project. There are many possible causes, including poor estimating, inaccurate job costing, sloppy project management (particularly with regard to change orders) and unexpected job-site problems.

Understandably, sureties don't like profit fade, so a pattern of declining profits can hurt your bonding capacity. To address this problem, evaluate your estimating procedures, job costing systems and management practices, and consider using more conservative estimates. A surety would prefer to see your estimated profits start at 4% and grow to 6% rather than start at 10% and shrink to 6%. But don't be *too* conservative, or sureties may question your estimating abilities.

A powerful diagnostic tool

WIP reports can be a powerful diagnostic tool. But like any tool, they're effective only if you use them properly. The reports should be prepared frequently — ideally, monthly — using accurate, timely information. And management should review the reports carefully and take prompt action to address any weaknesses or troublesome patterns they reveal.

Depending on the system you use to generate WIP reports, it may also be possible to organize WIP information by job type, location, contract size, and project manager or estimator, thus providing valuable insights into the factors that drive your construction company's profitability. ■



Is your tool reimbursement plan accountable?

If you permit or require employees to purchase their own small tools and then reimburse them for the expense, and the arrangement qualifies as an "accountable plan" under IRS rules, you — and your employees — can gain valuable tax benefits.

A significant tax difference

When a plan *isn't* accountable, expense reimbursements are included in employees' gross wages for tax purposes, and both the company and employees must pay employment taxes on those amounts. Although employees may be able to write off these expenses as miscellaneous itemized deductions, they'll benefit only if they itemize and only to the extent that their total miscellaneous deductions exceed 2% of their adjusted gross income.

Under an accountable plan, on the other hand, expense reimbursements are tax-free to employees and exempt from withholding and employment taxes. Plus, the company can still deduct them as business expenses (provided they otherwise qualify).

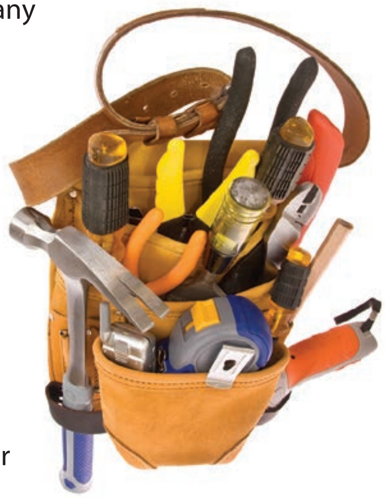
Making it accountable

A reimbursement plan is accountable if it:

1. Requires reimbursed expenses to have a business connection — that is, expenses must be related to an employee's work for the company and must otherwise be deductible by the employee,
2. Requires employees to substantiate expenses in writing within a reasonable time (60 days is a good rule of thumb), and
3. Requires employees to return any excess reimbursements or allowances within a reasonable time (120 days is a good rule of thumb).

Although accountable plans aren't required to be in writing, it's a good idea to document reimbursement policies and procedures. This can help ensure that the plan will pass muster with the IRS.

Employees should substantiate their expenses with expense statements or similar records that establish their business purpose, together with documentary evidence, such as receipts, canceled checks or bills. Many construction companies require receipts because they generally provide the best evidence of actual expense amounts.



Keep in mind that, even when these requirements are met, the IRS may reject a reimbursement plan if it finds that the employer is recharacterizing wages as expense reimbursements or allowances in order to gain a tax advantage. In a 2012 Revenue Ruling, for example, the IRS found that a company's reimbursement plan wasn't accountable when it reduced employees' hourly wages and made up the difference with a nontaxable "hourly tool rate." Once an employee's tool expenses were covered, his or her wages were returned to their previous hourly rate.

Easy and inexpensive

If you reimburse employees' tool expenses, be sure you have an accountable plan. These plans are relatively easy and inexpensive to establish, and they provide tax benefits for employers and employees alike. ■