CONT10

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Construction Contractors

Fort Worth, Texas
(800) 431-9025
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Interactive Self-study CPE

Companion to PPC's Guide to Construction Contractors

TABLE OF CONTENTS

Page

COURSE 1: ACCOUNTING FOR CONSTRUCTION CONTRACTORS

Overview 1

Lesson 1: GAAP for Construction Contractors, the Financial Reporting System, Cost Accumulation, and Revenue Recognition Methods 3

Lesson 2: Financial Statement Considerations, Investments in Ventures, and Accounting for Similar Operations 53

Glossary 113

Index 115

COURSE 2: CALCULATING INCOME TAX FOR CONSTRUCTION CONTRACTORS

Overview 117

Lesson 1: Calculating Current Income Taxes, AMT, and Look-back 119

Lesson 2: Other Tax Issues Facing Contractors 181

Glossary 223

Index 227

COURSE 3: CONSULTING SERVICES

Overview 229

Lesson 1: Consulting–General Guidance 231

Lesson 2: Consulting–Financing Services 257

Lesson 3: Consulting—Claim Settlement Services 297

Glossary 335

Index 337

To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

Course 1: Testing Instructions for Examination for CPE Credit 339
Course 1: Examination for CPE Credit Answer Sheet 341
Course 1: Self-study Course Evaluation 342
Course 2: Testing Instructions for Examination for CPE Credit 343
Course 2: Examination for CPE Credit Answer Sheet 345
Course 2: Self-study Course Evaluation 346
Course 3: Testing Instructions for Examination for CPE Credit 347
Course 3: Examination for CPE Credit Answer Sheet 349
Course 3: Self-study Course Evaluation 350

INTRODUCTION

Companion to PPC's Guide to Construction Contractors consists of three interactive self-study CPE courses. These are companion courses to PPC's Guide to Construction Contractors designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **July 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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Each course is divided into lessons. Each lesson addresses an aspect of construction contractors. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 1

ACCOUNTING FOR CONSTRUCTION CONTRACTORS (CONTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers various aspects related to accounting for construction contracts including topics such as the financial reporting system, revenue recognition methods, a variety of financial statement considerations, and investments in ventures, among other issues.

PUBLICATION/REVISION DATE: July 2010

RECOMMENDED FOR: Users of *PPC's Guide To Construction Contractor*s

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of construction contractors

CPE CREDIT: 8 QAS Hours, 8 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **July 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—GAAP for Construction Contractors, the Financial Reporting System, Cost Accumulation, and Revenue Recognition Methods

Completion of this lesson will enable you to:
- Define GAAP for construction contractors, the financial reporting system and cost accumulation.
- Identify revenue recognition methods, which one to use and under what circumstances.

Lesson 2—Financial Statement Considerations, Investments in Ventures, and Accounting for Similar Operations

Completion of this lesson will enable you to:
- Summarize financial statement considerations and their effect on accounting for construction contracts.
- Describe investments in ventures and accounting for similar types of businesses.

TO COMPLETE THIS LEARNING PROCESS:

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Thomson Reuters
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CONTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: GAAP for Construction Contractors, the Financial Reporting System, Cost Accumulation, and Revenue Recognition Methods

INTRODUCTION

Whenever one thinks about accounting for the construction industry, two accounting concepts normally come immediately to mind—the percentage-of-completion (PC) method and the completed-contract (CC) method. The accounting profession has accepted and used these two accounting methods for many years, and an abundance of literature has been written to explain their use. However, even the most seasoned accountant finds the methods extremely complex and difficult to master. Moreover, confusion often exists regarding whether the PC method and the CC method are alternatives or whether their use is dictated by the unique economic, industry, and accounting circumstances of each contractor.

Perhaps one reason that contract accounting is difficult to master is because it is difficult to explain in a logical and concise manner. One common approach to explaining the subject is a detailed discussion of the mechanics of the PC and CC methods. However, that approach bypasses many of the important underlying concepts common to both methods. Another approach is to start at the concept level, then gradually progress to a final explanation of the PC and CC methods. However, the underlying concepts are so numerous and complex that this building block approach often leaves the busy accountant frustrated because of the need to know the final answer, now!

Given the preceding difficulties, a presentation approach has been chosen that attempts to reach a compromise between the two approaches. In this lesson, the discussion first presents an overview of the PC and CC methods along with a list of the other accounting conventions unique to contractors. Next, the discussion focuses on a more detailed discussion and explanation of the accounting concepts common to both the PC and CC methods. Then, the PC and CC methods are revisited for a nuts and bolts discussion that includes illustrations.

The financial statement presentation rules for contractors and other accounting issues are discussed in the remaining sections of this lesson. While construction contractors are generally subject to the same reporting and disclosure requirements as other commercial entities, some unique factors need to be considered when preparing financial statements and related footnotes for a contractor. Contractors frequently participate jointly with other entities to share risks, combine financial and other resources, or obtain financing or bonding. Applying contractor accounting principles is appropriate for some similar business activities, including homebuilders and certain manufacturing activities). Finally, this lesson presents summarized information about some common problems associated with construction accounting.

Learning Objectives:

Completion of this lesson will enable you to:

- Define GAAP for construction contractors, the financial reporting system and cost accumulation.
- Identify revenue recognition methods, which one to use and under what circumstances.

GAAP FOR CONSTRUCTION CONTRACTORS

Generally accepted accounting principles (GAAP) are applicable to all financial statements (except statements presented on an other comprehensive basis of accounting, such as cash basis statements) and are important to all accountants (whether in industry or public accounting) who are concerned with producing meaningful financial statements.

The FASB Accounting Standards Codification

In June 2009, the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification ™ and the Hierarchy of Generally Accepted Accounting Principles*, to establish the FASB Accounting Standards Codification (FASB ASC or

the Codification) as the source of authoritative accounting principles recognized by the FASB to be used by nongovernmental entities when preparing financial statements in accordance with GAAP in the United States. SFAS No. 168 became effective for financial statements issued for interim and annual periods ending after September 15, 2009.

SFAS No. 168 essentially reduced the GAAP hierarchy to two levels: authoritative and nonauthoritative. Authoritative GAAP is contained in the Codification and, except for certain grandfathered and transitional standards, non-SEC accounting literature that is not contained in the Codification is considered nonauthoritative. All guidance in the Codification is deemed to have the same level of authority. In creating the Codification, the FASB arranged the existing sources of historical GAAP, such as Statements of Financial Accounting Standards (SFASs), Statements of Position (SOPs), and other pronouncements that populated the prior GAAP hierarchy into a topical structure maintained in an online research platform. Upon the effective date of SFAS No. 168, all existing sources of non-SEC accounting and reporting standards were superseded, except for certain grandfathered and transitional standards that were awaiting integration into the Codification.

The Codification also includes SEC guidance that is relevant only to SEC registrants. The SEC guidance is segregated from non-SEC guidance so accountants can clearly identify which guidance relates only to public entities versus nonpublic nongovernmental entities. The SEC oversees and controls its literature, but works with the FASB to include its guidance in the Codification.

The Organization of the codification. The Codification is organized as follows:

a. *Topics.* Topics represent a collection of related guidance, such as Leases. The following are the main types of topics:

   (1) *General Principles (Topic Codes 105–199).* These topics relate to broad conceptual matters, such as generally accepted accounting principles.

   (2) *Presentation (Topic Codes 205–299).* These topics relate only to presentation matters and do not address recognition, measurement, or derecognition matters. Such topics include income statement, balance sheet, statement of cash flows, etc.

   (3) *Financial Statement Accounts (Topic Codes 305–700).* These topics are organized in a financial statement order including assets, such as receivables and inventory; liabilities; equity; revenue, such as revenue recognition; and expenses.

   (4) *Broad Transactions (Topic Codes 805–899).* These topics relate to multiple financial statement accounts and are generally transaction-oriented. Such topics include business combinations, derivatives, nonmonetary transactions, etc.

   (5) *Industries (Topic Codes 905–999).* These topics relate to accounting that is unique to an industry or type of activity. Such topics include airlines, software, real estate, etc. The construction contractor industry is topic code 910.

b. *Subtopics.* Subtopics represent subsets of a topic and are generally distinguished by type or by scope. For example, operating leases and capital leases are two subtopics of the leases topic distinguished by type of lease. Each topic contains an overall subtopic that generally represents the pervasive guidance for the topic. Each additional subtopic represents incremental or unique guidance not contained in the overall subtopic. Subtopics unique to a topic use classification numbers between 00 and 99.

c. *Sections.* Sections represent the nature of the content in a subtopic such as recognition, measurement, disclosure, and so forth. Every subtopic uses the same sections, unless there is no content for a particular section.

New standards issued are in the form of an Accounting Standards Update generally composed of a summary, amendments to the Codification, a background and basis for conclusions section, and amendments to the XBRL taxonomy, if any. The Accounting Standards Updates are numbered with a format YYYY-XX, where YYYY is the year

the Accounting Standard Update is issued and XX is the sequential number of each Update, such as 2010-01, 2010-02, etc. All authoritative GAAP issued by the FASB will be issued in this format, regardless of the form in which such guidance may have been issued previously (for example, EITF Abstracts, FASB Staff Positions, FASB Statements, FASB Interpretations, etc.).

What Is GAAP for Contractors?

GAAP for construction contractors can be found in the revenue and industry topic codes:

- FASB ASC 605-35 (formerly ARB No. 45, *Long-Term, Construction-Type Contracts*, and SOP 81-1, *Accounting for Performance on Construction-Type and Certain Production-Type Contracts*), provides guidance on accounting for contracts of commercial organizations engaged wholly or partly in the contracting business.

- FASB ASC 910 (formerly the AICPA Audit and Accounting Guide, *Construction Contractors*), provides additional accounting guidance. (The AICPA Guide also includes information on operations and auditing guidance.)

Revenue Recognition Methods Used by Construction Contractors

Under GAAP, there are two methods of recognizing revenues on construction contracts:

a. The percentage-of-completion (PC) method, which must be used in most instances, allows the contractor to recognize income throughout a contract's life. Under this method, a contractor computes the extent of progress toward completion for each contract in progress at a given point in time. For example, if a contract is 68% complete on a particular date, the contractor recognizes 68% of the contract's revenues, estimated costs, and gross income at that date.

b. The completed-contract (CC) method, which defers income recognition until a contract is substantially complete, should be used only in those rare instances when the PC method cannot be used. Under this method, revenues, costs, and gross income are not recognized throughout the life of a contract. Instead, the income statement amounts are recognized only when the project is complete.

These two methods do not represent alternatives from which a contractor is free to choose. SOP 81-1 (FASB ASC 605-35) establishes a strong preference for the PC method, virtually requiring that it be used as the basic method of accounting by most contractors. The PC method depends upon a contractor's ability to make reasonably dependable estimates regarding the extent of progress toward completion for each contract. Since estimating is an essential part of a contractor's business, there is a general presumption that most contractors can make sufficiently dependable estimates.

The only time the CC method should be used is when either of the following conditions exists:

a. The results do not vary materially from those achieved under the PC method, or

b. With persuasive evidence, the contractor can overcome the basic presumption that it has the ability to make reasonably dependable estimates.

Other Accounting Considerations Unique to Contractors

Beyond the GAAP requirement to use the PC method for most contract situations, several other accounting conventions are important or unique to construction contractors, including:

a. The accrual method must be used to account for billings and costs.

b. Construction-related costs, revenues, and earnings must be summarized by profit center. Although each contract normally represents one profit center, there are exceptions to this rule. It is therefore important to properly identify the appropriate profit centers.

c. Types of costs to be allocated to contracts generally fall into three categories:

   (1) Directly identifiable costs that relate specifically to a construction project.

   (2) Indirect costs that relate to the construction process in general. (These indirect costs are normally included in an overhead pool and then allocated to individual contracts using some rational basis.)

   (3) Construction period interest on debt that is necessary to finance construction activity.

d. Costs (and estimated earnings) in excess of billings on contracts in progress (also referred to as *underbillings*) are recorded as assets while billings in excess of costs (and estimated earnings) (also referred to as *overbillings*) are shown as liabilities. An overbilling situation, while a liability account, indicates that the contractor has bid its work in a manner such that the contract owner assists the contractor in financing the job. An underbilling situation, although an asset on the balance sheet, may indicate poor billing or bidding practices, or might also indicate overly aggressive profitability forecasts.

e. All losses expected to be realized on contracts in progress should be recorded in the period they become known.

f. Investments in construction ventures must be accounted for as follows:

   (1) If the contractor exercises *control* over a venture as a result of its investment, the venture normally must be consolidated with the contractor for reporting purposes. A contractor that owns more than 50% of a venture usually exercises sufficient control to justify using the consolidation method.

   (2) If the contractor is the primary beneficiary of a variable interest entity created after December 31, 2003 and control is achieved other than through voting interests, the venture must be consolidated.

   (3) If the contractor exercises *significant influence* over a venture, but does not control it, the contractor normally must use the equity method of accounting for its investment. Significant influence normally occurs when the ownership percentage is between 20% and 50%.

   (4) If the contractor is unable to exert significant influence over a venture, the cost method of accounting for the contractor's investment is generally appropriate. The cost method is usually used for investments of less than 20% of a venture.

The unique accounting considerations mentioned above apply regardless of whether the PC or the CC revenue recognition method is used. The next several sections address these unique accounting considerations in greater detail.

THE FINANCIAL REPORTING SYSTEM

Fundamental to an understanding of the GAAP accounting rules that should be followed by a construction company is a basic understanding of the financial reporting systems contractors most often use. The following aspects of a contractor's financial reporting system are discussed:

a. Determining the profit center.

b. Field reports.

c. Subsidiary records.

d. The general ledger.

e. Adjusting the financial statements.

Determining the Profit Center

While the profit center for most entities is the company as a whole, the profit center for a construction company is normally each individual contract. Authoritative guidance for construction contractors defines the profit center as

the unit for the accumulation of revenues and costs and the measurement of income. GAAP further states that the basic presumption should be that each contract represents a separate profit center; that is, costs and revenues are generally accumulated and income is normally measured on a contract-by-contract basis. This basic presumption can only be overcome by persuasive evidence to the contrary. Unless clearly indicated otherwise, the terms *contract* and *profit center* are used interchangeably in this lesson.

In specific limited circumstances, the profit center can be defined as something other than each contract. If certain conditions are met, a group of contracts can sometimes be *combined* into one profit center, or a single contract can sometimes be *segmented* into more than one profit center.

General Rules for Combining Contracts. FASB ASC 605-35-25-8 (formerly SOP 81-1) states that a group of contracts may be combined for accounting purposes if the contracts:

a. Are negotiated as a package in the same economic environment with an overall profit margin objective. Contracts not executed at the same time may be considered to have been negotiated as a package in the same economic environment only if the time period between the commitments of the parties to the individual contracts is reasonably short. The longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

b. Constitute, in essence, an agreement to do a single project. A project for this purpose consists of construction, or related service activity, with different elements, phases, or units of output that are closely interrelated or interdependent in terms of their design, technology, and function or their ultimate purpose or use.

c. Require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases, or units of output.

d. Are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.

e. Constitute, in substance, an agreement with a single customer. In assessing whether the contracts meet this criterion, the facts and circumstances relating to the other criteria should be considered. In some circumstances, different divisions of the same entity would not constitute a single customer if, for example, the negotiations are conducted independently with the different divisions. On the other hand, two or more parties may constitute, in substance, a single customer if, for example, the negotiations are conducted jointly with the parties to do what in essence is a single project.

Contracts that meet all of these criteria may be combined for profit recognition and for determining the need for a provision for loss in accordance with FASB ASC 605-35-25 (formerly ARB No. 45, Paragraph 6). The criteria should be applied consistently to contracts with similar characteristics in similar circumstances.

When the combining criteria are met, the group of combined contracts becomes a profit center for purposes of accumulating costs, revenues, and earnings. The combined results of operations could vary significantly from the results obtained if each contract were accounted for separately. Thus, care must be taken to ensure that contracts are not combined into a profit center solely to prevent losses on a particular contract from being recognized early in the estimating process.

General Rules for Segmenting Contracts. SOP 81-1 at Paragraphs 40 and 41 (FASB ASC 605-35-25-12, 13) states that a project may be segmented if *all* of the following steps were taken and *are documented and verifiable*: [emphasis added]

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.

b. The customer had the right to accept the proposals on either basis.

c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

A project that does not meet the (aforementioned) criteria may be segmented *only if it meets all* of the following criteria: [emphasis added]

a. The terms and scope of the contract or project clearly call for separable phases or elements.

b. The separable phases or elements of the project are often bid or negotiated separately.

c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.

d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed.

e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions (responding, for example, to extraordinary economic circumstances or to unique customer-contractor relationships).

f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations (for example, cost savings in supervision, overhead, or equipment mobilization). Unless this condition is met, segmenting a contract with a price substantially less than the sum of the prices of the separate phases or elements would be inappropriate even if the other conditions are met. Acceptable price variations should be allocated to the separate phases or elements in proportion to the prices ascribed to each. In all other situations a substantial difference in price (whether more or less) between the separate elements and the price of the total project is evidence that the contractor has accepted different profit margins. Accordingly, segmenting is not appropriate, and the contracts should be the profit centers.

g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

If the criteria for segmenting are met, the individual phase would become the profit center for purposes of accumulating costs and recognizing revenue and income/loss. The profit margin for each phase may differ from the profit margin obtained if the phases were treated as one contract.

Conclusion Regarding Combining and Segmenting Contracts. Rarely are the criteria for either segmenting or combining met. Therefore, in nearly all situations, the profit center will be an individual contract. If significant contracts are to be combined or segmented, the accountant (especially in an audit, review, or compilation engagement) should consider documenting the justification for the accounting.

Field Reports

Most construction companies have problems collecting information from the field. Many contractors require daily reports while others require them less frequently. Best practices indicate that the reports should be submitted at least weekly. Each contractor should develop its own report based on its size, location of projects, and other needs. Whether the reports are submitted daily or less frequent, some of the information should be detailed daily.

Best practices indicate that the report be preprinted with spaces for the requested information. The following information should be considered for inclusion in the report:

- Timecard summaries.
- New employees.

- Employee terminations and resignations.
- Description of injuries during the period.
- Supplier invoices received.
- Daily weather information.
- Narrative description of job progress.
- Change orders received during the period including who received from, when received, summary description of conditions relating to the order, and whether signed or not signed.
- Summary of important discussions with planning and zoning personnel, union leaders, suppliers, etc.
- Description of other job site conditions.
- Other information.

Photographs, video, and/or audio can be important supplements to the field reports, especially when claims are or may be involved. Exhibit 1-1 is an example field report.

Exhibit 1-1

Illustrated Field Report[a]

[Name of Company]

Project: _____ Period ended: _____

Prepared by: _____

1. Payroll Information:[b]

Name	Social Security No./Employee No.[c]	Hours

2. New Employees:[d]

   - Attach forms required for new employees.

Name	Social Security No./Employee No.[c]	Position

3. Employee Terminations and Resignations:

Name	Social Security No./Employee No.[c]	Position

4. Injuries during the Period:

   - Provide name of injured individual, nature of injury, conditions leading to the injury, and present condition of injured person.

_____

_____

_____

5. Supplier Invoices:

   - Attach approved invoices for payment or indicate none.

6. Daily Weather Information:[e]

   Monday: _____

   _____

   Tuesday: _____

   _____

Wednesday: _____

Thursday: _____

Friday: _____

Saturday: _____

Sunday: _____

7. Narrative Description of Job Progress: _____

8. Change Orders Received during the Period:

   - Include information as to from whom received, when received, summary description of conditions relating to the order, and whether signed or not.
   - Additional information on change orders reported previously, such as signed orders (that were previously unsigned), efforts to obtain signed orders, and problems (construction or other) encountered relative to change orders.

9. Summary of Important Discussions:

   - With suppliers, union leaders, planning and zoning personnel, etc.
   - Indicate time, date, who discussion was with, summary of conversation, and others who were present.

10. Description of Other Job Site Conditions:

11. Other Information:

    - Provide other information considered important.

Notes:

[a] This is intended only as an illustration of a field report. It is suggested that contractors design a field report that reflects the entity's unique needs. Individual contractors may not need all of the items illustrated, whereas most contractors will have unique needs not included. Nature of contracts, size of project, size of contractors, payroll procedures, and other unique characteristics of each contractor will determine such needs.

[b] Contractors who submit time cards to the accounting department may not include this listing. Other contractors may list other information such as pay rates.

[c] Due to increased identity theft, the use of an alternative employee identification number instead of the employee's social security number is recommended. If the contractor continues to use social security information on the field report, the company should develop procedures to protect the confidentiality of such information.

[d] Contractors may wish to list the forms it requires such as W-4, Form I-9, and insurance forms.

[e] When weather is not a factor in completing the project, there may be no need for this information.

* * *

Some contractors have created field reports that may be electronically transmitted to the office. The person responsible for completing the field reports logs onto the contractor's website and completes the field report online. Additionally, some construction management software systems include electronic field report capability. An electronic submission process may improve the timeliness of the filing of field reports.

Handheld computers, also known as personal digital assistants (PDAs), are becoming increasingly popular with contractors. PDAs can function as organizers, mini-computers, cellular phones, faxes, and cameras. The field report may be downloaded from the desktop computer to the PDA or uploaded from the PDA to the desktop computer. In addition to field reports, inexpensive PDA software is available for a variety of uses including:

- Punch listing.
- Dimension calculations.
- Drawing and viewing schematic diagrams.
- Detailed time tracking.

Subsidiary Records

Because each individual contract is a profit center, the financial reporting system for a construction contractor must identify and accumulate revenue, cost, gross profit, and billing information on a contract-by-contract basis. Most contractors accomplish this through subsidiary records. Subsidiary records often contain both legal documents and accounting information. The records vary in degree of sophistication from file folders and hand-posted ledger cards to computer generated reports. In general, these records should contain the following information:

a. Legal documents, including the signed contract, change orders, correspondence, etc.

b. Cost estimation worksheets, blueprints, plans, status reports, etc.

c. Cost accumulation records that capture material costs, labor charges, and overhead allocations for each contract.

d. Billing and accounts receivable records for each contract.

e. Worksheets showing how periodic revenue, cost, and gross profit totals were determined.

To be meaningful, the accounting information posted to the subsidiary records must be complete and accurate. Each contractor is responsible for designing procedures and controls to allocate all contract costs, billings, and other information to the appropriate subsidiary records. Although not intended to be comprehensive, the following factors should be considered in designing such a system:

a. Many direct costs, such as subcontractor charges and material purchases, are supported by vendor invoices. In some cases, the charges being invoiced will relate to only one contract, making the allocation easy. However, in other cases, charges on a single invoice will relate to more than one contract. For example, a painting subcontractor may work on several of a contractor's projects during a given week and send only one bill covering all work performed during the period. When this occurs, the contractor is responsible for obtaining enough information from the subcontractor to properly allocate the total invoice amount to the appropriate subsidiary contract records.

b. Many contract charges are allocated to contracts on a *time and usage* basis. Some construction employees, for example, may work on several projects during a pay period. The payroll costs for these employees may be allocated based on time sheets. Equipment charges, such as gasoline, maintenance, and depreciation, may be allocated to contracts based on equipment usage logs or some other rational basis.

c. Contractors often purchase large quantities of common inventory items. Such inventory is usually stored in a warehouse until it is needed at a job site. The transfer of inventory from the warehouse to a job site should be supported by a transfer or requisition form. Completing this form facilitates the posting of this transaction in the subsidiary records.

d. Overhead charges and interest should be allocated to all contracts in a consistent, rational manner.

These cost allocation issues, as well as other matters that should be considered in designing a subsidiary recordkeeping system, are discussed in more detail throughout the remainder of this lesson.

The General Ledger

There is a direct relationship between the subsidiary records previously discussed and the general ledger of a construction contractor. Information that is recorded on a contract-by-contract basis in the subsidiary records should also be recorded in the general ledger. In fact, a contractor's accounting staff should periodically reconcile contract information accumulated in the subsidiary records to the general ledger.

As previously mentioned, most contractors do not maintain their general ledgers on a GAAP basis. Many small contractors maintain their general ledgers in accordance with the methods used to file their tax returns, which might be the cash basis, accrual basis, or completed-contract basis of accounting. Regardless of size, very few contractors actually use a pure percentage-of-completion basis of accounting (which is usually the preferred method of recognizing revenues under GAAP) throughout the year.

Contractors use a variety of methods to record contract activity. Two of the more commonly used methods are as follows:

a. The direct P&L approach.

b. The construction-in-progress approach.

The Direct P&L Approach. Under this approach, revenue is recognized on each contract as billings are rendered (or collected if the cash method is used), regardless of whether those billings correspond to the actual work completed on the contract. Contract costs are charged directly to expense accounts when they are incurred (or paid if the cash method is used). No attempt is made to capitalize any construction costs in an inventory or construction-in-progress asset account.

This approach is popular because it is easy to apply and does not require a great deal of judgment. In some ways, it may also approximate the results obtained from the percentage-of-completion method if billings occur based on the achievement of certain stages of completion. Proponents of this method argue that contract costs should be expensed as incurred because title passes to the project owner immediately as work progresses. Since construction in progress is not owned by the contractor, it should not be recorded on the balance sheet.

The Construction-in-progress Approach. This approach is similar to the direct P&L approach in that revenue is recognized when billings are rendered or collected. However, this approach calls for a two-step process for recording contract costs. Costs are first debited to a construction-in-progress asset account as incurred or paid. They are not expensed until a bill is rendered.

Adjusting Financial Statements to a GAAP or Tax Basis

The "Percentage-of-completion Calculation Workpaper" is a worksheet that can be used to properly account for contract activity for both GAAP and tax purposes. By completing this worksheet for each contract in progress as of a balance sheet date, a contractor can determine the adjustments that are required to properly state financial statements at the appropriate basis.

COST ACCUMULATION

GAAP Cost Accumulation Rules

One of the most critical requirements for properly applying either the PC or CC method is the identification and accumulation of project costs on a contract-by-contract basis. Historically, cost accumulation has been accomplished within the financial reporting system by using separate contract cost records, cards, or ledgers for each contract in progress. However, in recent years, the cost of computer hardware, as well as accounting and job-cost application software available to contractors, have decreased enough so that even small contractors can operate more effectively by using a computerized information-gathering and job-cost tracking system.

Guidance about the types of costs that should be accumulated for each contract in accordance with GAAP is found in FASB ASC 605-35-25-34 (formerly SOP 81-1 at Paragraph 69), which is partially reproduced as follows:

> Contract costs are accumulated in the same manner as inventory costs . . . (they) generally include all *direct costs*, such as materials, direct labor, and subcontracts, and *indirect costs* identifiable with or allocable to the contracts. [Emphasis added.]

Besides the above required contract cost components, FASB ASC 835-20-15-5 (formerly SFAS No. 34) requires the capitalization of interest costs on assets that are constructed as discrete projects for sale or lease to customers. Construction projects usually qualify for interest capitalization. The following paragraphs discuss in greater detail the cost components of a contract.

When contractors accumulate construction costs, best practices indicate that their accountants consider the following—

- Has the contractor developed allocation methods that result in a high degree of comparability between actual costs and estimated costs? If not, the contractor's allocation methods should be revised to accomplish that result.

- Has the contractor compared its operating margins and overhead percentages with others in the same industry segment? Such a comparison will provide an indication if the construction contractor has appropriately developed cost allocation methods.

The importance of proper job costing (and job estimating) can not be overstated as it impacts not only revenue recognition, but also the contractor's cash flow (due to underbilling for work already performed) and profitability (due to the lack of including all properly chargeable costs incurred in the performance of the work).

Direct Costs

It is often easy to identify and properly classify direct costs because they are normally unique to a specific contract. Examples of direct costs include the following:

a. Materials used directly in the construction of a project.

b. Construction labor.

c. Subcontractor charges.

d. Other direct costs that can be easily identified with a specific contract, such as travel and other costs incurred by construction crews who work on out-of-town jobs, rental costs of equipment used only on specific jobs, performance bond premiums, etc.

Direct Materials. Materials that are used directly to construct a project should be capitalized as a project cost component for both GAAP and tax purposes. The amount capitalized should include all cost components, including freight costs. Recording direct materials generally occurs in two ways:

a. Certain materials are common to many jobs and are routinely purchased in bulk and kept in the contractor's warehouse. These materials are normally carried as "inventory" until needed for a particular job, at which time the materials are assigned to the specific contract. The materials are then physically moved to and installed at the job site, and an accounting entry should be made to debit job costs and to credit inventories.

b. Other materials may be purchased for use only on a specific contract, either because they are unique to that contract or because sufficient levels are not already available in the warehouse. Most contractors will not actually record these materials as inventory, choosing instead to debit job costs directly when the materials are received.

To illustrate the preceding process, assume an electrical contractor is awarded a contract to install the electrical wiring and fixtures for a new art museum. The contractor may already have most of the materials that will be used on this project, such as wire, cables, breaker boxes, sockets, and switches; however, the contractor must order certain other materials specifically for this project. In this example, contract costs will include both materials transferred from inventory and materials purchased specifically for the museum contract.

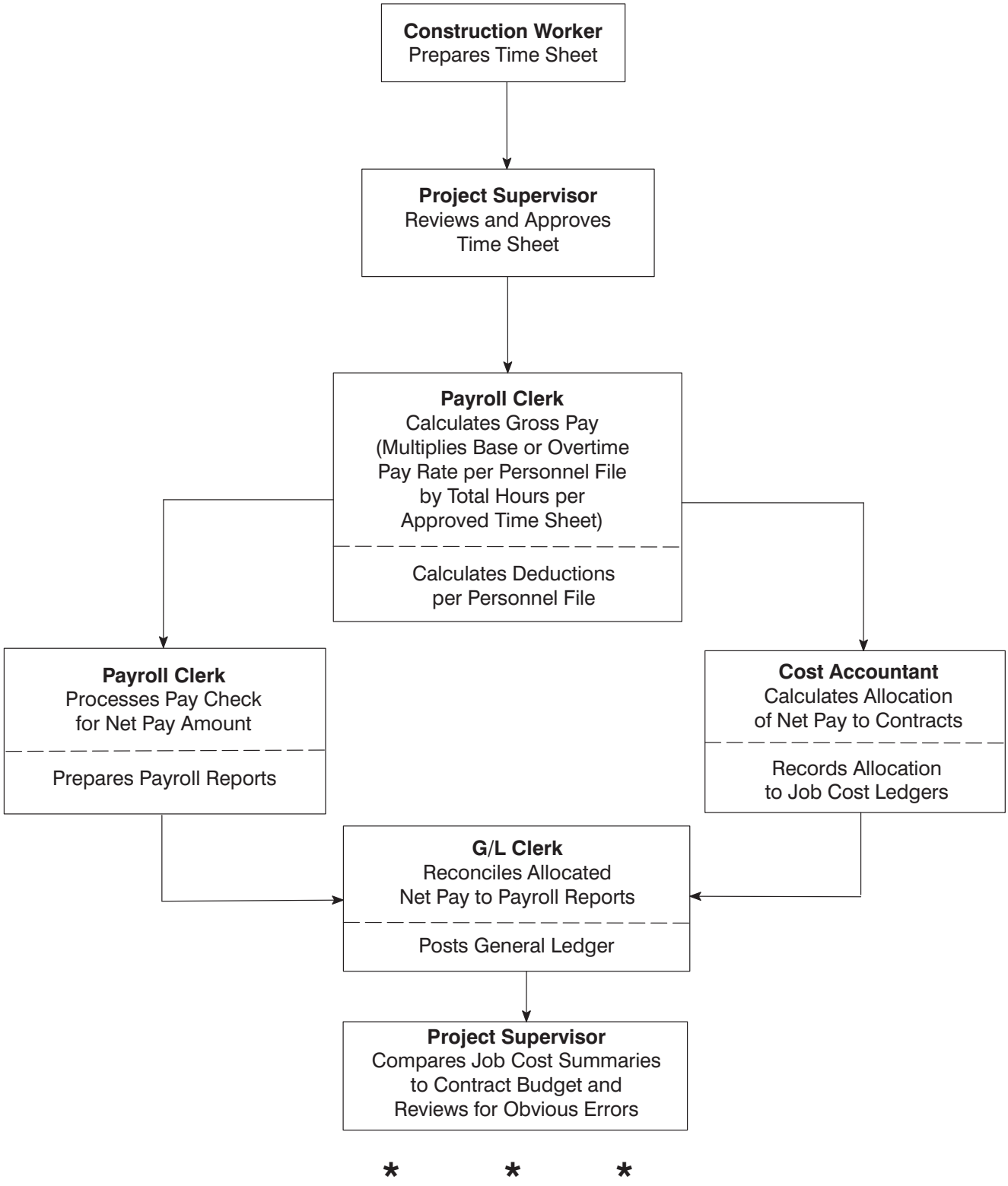
Leftover Materials. After a project has been completed, leftover materials are normally returned to the warehouse if the contractor feels that they can be used on future jobs. These returned materials should be recorded as inventory at the lower of original cost or net realizable value. Any declines in value that have occurred before the materials are returned should be charged to the related contract. Certain inventory costs, such as idle facility expense, excessive spoilage, double freight, and rehandling costs, should be recognized as current-period charges.

Direct Labor. Direct labor includes the payroll cost of construction workers, field supervisors, and others who charge time directly to contracts. The payroll cost charged to contracts should include wages, vacation and holiday pay as well as all payroll related costs, for example, payroll taxes, workers' compensation insurance, and fringe benefits, such as health insurance and retirement plans. As a practical matter, many contractors treat payroll taxes, workers' compensation insurance, and fringe benefits as indirect costs to be allocated as overhead costs.

Besides being an important component of total contract costs, direct labor hours or dollars is one of the most commonly used bases for allocating indirect costs among the contracts in progress during a period. If an error occurs in accumulating labor hours, the error can have a compounded effect on the contractor's financial statements; that is, not only may the direct labor component of total job costs be wrong, indirect costs may also be incorrectly allocated to the contracts. Exhibit 1-2 presents an overview of a typical direct labor processing stream that has been designed to minimize errors.

Exhibit 1-2

Overview of a Typical Direct Labor Processing Stream



* * *

Subcontractor Costs. Construction contractors often use other companies or individuals to perform a segment of the work required on a contract. This practice is especially common among general contractors, who frequently

engage specialists, such as electricians, brick masons, painters, and heating and air contractors to complete a project. These specialists are normally hired under subcontract agreements, which are often similar to the agreements between general contractors and owners. Costs incurred under subcontract agreements represent direct costs that should be capitalized directly to the related contracts.

Billings from subcontractors will typically be made in accordance with the subcontract terms. To ensure completion of the subcontract project, the general contractor will pay only a portion of the subcontractor's bills throughout the subcontract life, with the remainder being held as retainage until satisfactory completion of the project. The amount that should be recorded as a direct contract cost is the total amount of the billing, not just the amount paid. For example, assume that a general contractor has a subcontract agreement with a landscape contractor that allows the subcontractor to bill $20,000 per month during the five-month life of the project. Assume further that the contractor pays only 90% of this amount, or $18,000 per month, with the remaining unpaid retainage due upon the owner's acceptance of the landscaping. The general contractor should record the following entry as the monthly bills are received and paid:

	DR	CR
Contract costs	$ 20,000	
Cash		$ 18,000
Account payable to subcontractor		2,000

When the five-month life of the project is completed, the general contractor should have charged $100,000 of direct contract costs relating to the landscaping subcontract, of which $90,000 will have been paid and $10,000 will still be due.

Other Direct Costs. Other direct costs are costs related to a specific contract, not included in one of the preceding categories. Other direct costs generally include such items as short-term equipment rental costs, surety bonds, job site utilities, and certain precontract costs.

Indirect Costs

Indirect costs (also called overhead costs or general conditions costs) that should be capitalized as contract costs are generally more difficult to quantify than direct costs. The process involves the following two steps:

a. Determining the kinds of indirect costs that should be capitalized; and

b. Developing a systematic and rational method for allocating those costs to individual contracts.

Common Indirect Costs. Determining which types of indirect costs should be allocated to contracts is a judgmental process that involves the same basic considerations that a manufacturer uses to allocate overhead costs to inventory. Examples of indirect costs that are normally allocated to contracts are:

a. Rent, utilities, depreciation, and other costs related to construction facilities, such as storage buildings and assembly plants.

b. Rent, depreciation, repairs, and other operating costs of general construction equipment used on many jobs.

c. Compensation, fringe benefits, workers' compensation insurance, and payroll taxes for indirect labor, such as foremen. Also, if direct labor costs charged directly to contracts do not include related payroll taxes, workers' compensation insurance, medical insurance, and other fringe benefits, those components of direct labor should be categorized as indirect costs to be allocated to the contracts.

d. Quality control and inspection.

e. Small tools and general construction supplies.

f. Contractor's liability insurance.

Identifying the Components of an Overhead Pool. All indirect costs related to the construction process should be identified and included in an overhead pool or pools to be allocated to the construction costs of individual contracts. Overhead pools are most often used by contractors for labor burden, equipment ownership and operating costs, materials handling, shop and yard costs, vehicle costs, job management overhead costs, and general conditions cost. Determining overhead pools and the allocation of those costs generally depend on the type of work and amount of costs incurred. For example, a general contractor may choose to lump various costs together in one pool because they account for a small percentage of the general contractor's total cost, while a subcontractor may use two or more separate cost pools for those same costs because they represent a significant percentage of the subcontractor's total costs. Best practices indicate that the following guidelines be considered in determining the components of the overhead pool(s):

a. If the indirect cost was incurred solely to benefit the construction activity, all of that cost should be included in the overhead pool. For example, small tools and contract supplies would normally meet that criterion. Also, costs other than direct costs, specified as reimbursable costs in cost-type contracts, also would be considered overhead.

b. If the indirect cost does not relate to the construction activity, none of it should be considered in the overhead pool. For example, the salary of an administrative employee, such as the receptionist or an administrative vice president, should not be included in the overhead pool.

c. If a portion of the cost relates directly to the construction activity, consider only that portion in the overhead allocation. Gasoline, for example, may be used in construction equipment and in a salesman's car. Only that portion relating to the construction activity should be included in the overhead pool. The portion to be capitalized should be based on reasonable estimates, and, if that portion is likely to be material year after year, a consistent approach should be used.

Methods of Allocating Overhead. GAAP for construction contracts allows a variety of methods for allocating overhead costs among contracts. They include allocations based on direct labor hours, direct labor costs, or combinations of direct labor and material costs. Because significant variations can result in contract costs and resulting operations depending on which method is selected, the contractor must be sure that the method used is systematic, rational, and consistent from year to year. For example, a landscaping contractor is highly labor intensive and would probably not want to allocate overhead based on materials costs.

The approach most contractors use to allocate overhead involves using overhead burden rates. In this approach, a burden rate is computed by dividing total overhead by the total of the allocation base selected, for example, total direct labor costs or total materials costs. This burden rate is then applied to the allocation base for each contract to arrive at the amount of overhead to be allocated to the contract.

Exhibit 1-3 illustrates the use of this method to allocate overhead of $17,500.

Exhibit 1-3

Examples of Overhead Allocation Methods

Allocation based on direct labor costs of $59,000

Burden rate: $17,500 ÷ $59,000 = 29.66%

	Direct Labor	×	Burden Rate	=	Allocated Overhead
Contract A	$ 23,000		29.66%		$ 6,822
Contract B	4,000		29.66%		1,186
Contract C	32,000		29.66%		9,492
	$ 59,000				$ 17,500

Allocation based on materials costs of $63,700

Burden rate: $17,500 ÷ $63,700 = 27.47%

	Materials	×	Burden Rate	=	Allocated Overhead
Contract A	$ 21,000		27.47%		$ 5,769
Contract B	13,200		27.47%		3,626
Contract C	29,500		27.47%		8,105
	$ 63,700				$ 17,500

* * *

Capitalizing Construction Period Interest. If a company constructs an asset for its own use or constructs *discrete projects* for sale or lease, FASB ASC 835-20-15-15 (formerly SFAS No. 34) requires that interest costs be capitalized as a part of the asset's cost. Normally, any contractor who has substantial outstanding debt to finance ongoing construction activities will have interest cost that is a candidate for allocation to individual contract costs. Both GAAP and tax rules require the capitalization of construction period interest.

Other Cost Considerations

Costs in Cost-plus Contracts. Costs reimbursable under cost-plus contracts may or may not qualify for capitalization under GAAP. For example, certain contracts may not allow the contractor to bill for interest costs even though they qualify for interest capitalization under GAAP. Alternatively, other contracts may allow the contractor to bill for certain selling expenses even though those expenses are not capitalizable under GAAP. Costs under cost-plus contracts should be capitalized according to GAAP even if they conflict with the terms of the contract. If the estimated capitalized costs ever exceed the amounts billable, the contractor should consider establishing a reserve for loss.

Equipment Costs. Different contractors take varying approaches to owning or leasing construction equipment. Some contractors own little or no equipment and rent whatever is necessary to complete a given job, while other contractors invest heavily in construction equipment. Whether leased or owned, all contractors must establish a

method to allocate equipment costs to specific contracts. Equipment costs, which include depreciation, repairs, maintenance, taxes, interest, and insurance, can be charged to contracts in a variety of ways, including:

a. Charging the cost of equipment used on the job to the contract as a direct charge and charging costs that cannot be specifically identified to overhead.

b. Allocating depreciation directly to the job and charging other equipment costs, such as repairs or maintenance, to overhead.

c. Charging all equipment costs to an equipment cost pool and allocating to jobs.

d. Charging all equipment costs to overhead and allocating the costs along with the other overhead expenses.

Some contractors use combinations of these methods. Regardless of the method or methods adopted, equipment costs should be allocated to contracts in a consistent manner. Whichever method is used, equipment costs should be charged to a specific contract using a method that reflects the extent that construction equipment was used on that job.

Equipment Cost Pools. Some construction contractors have established equipment cost pools to accumulate equipment costs. Standard equipment usage rates (such as hours, days, miles, etc.) are charged to contracts as the equipment is used. The rates are generally based on projected equipment usage and the total costs projected for the year. The difference between the actual costs incurred (total costs charged to the cost pool) for the year and the total credits to the cost pool (total amounts charged to contracts at standard rates) is referred to as an equipment variance.

Questions have arisen as to the accounting for the variance. The occurrence of a variance indicates that the standard rates differ from actual costs. Since GAAP requires that construction in progress be stated at cost net of billings (unless projected costs exceed contract revenue), the variance, if material, should be allocated in a logical and consistent manner between completed contracts and contracts in progress. One logical method of allocation is the ratio of the total credits to the cost pool for completed contracts to the total credits for contracts in progress for the year (or period). This method is illustrated as follows:

Assumptions:		
Credits to cost pool for:		
Completed contracts	$ 70,000	70%
Contracts in progress	30,000	30%
Total	$ 100,000	100%
Variance remaining in cost pool	$ 10,000	
Allocation of variance:		
Completed contracts—$7,000 (70% × $10,000)		
Contracts in progress—$3,000 (30% × $10,000)		

The variance can be further allocated between specific completed contracts and contracts in progress using the same method.

Some accountants question this method when a contractor's equipment is idle for significant periods of time such as during the winter season. FASB ASC 910-20-25-3 (formerly the AICPA Audit and Accounting Guide, *Construction Contractors*, at Paragraph 2.23) indicates that it is proper to allocate idle equipment costs to jobs. It points out that this practice is consistent with the rates lessors charge (except for the profit element).

In many instances, the variance is not a material amount and need not be allocated. In these cases, the variance is usually charged or credited to the cost of completed contracts.

Selling, General, and Administrative Expenses. As a general rule, all costs that are not directly or indirectly associated with the construction process should be classified as selling, general, and administrative expenses. The

only exception relates to the possible capitalization of certain general and administrative costs if the completed-contract method is used, particularly in years when no contracts are completed.

Precontract Costs. Contractors sometimes incur costs in anticipation of future contract sales in situations such as the following:

a. Costs are incurred in anticipation of obtaining a specific contract. The costs will have no future benefit if that contract is not obtained. A common example is architectural and engineering fees incurred to develop specifications that are submitted in a proposal to construct a project such as a city stadium.

b. Costs are incurred for assets to be used in connection with specific anticipated contracts. For example, a contractor might acquire a portion of the building materials required for a job before acceptance of the proposal because of favorable supplier terms.

c. Learning or start-up costs are incurred in connection with existing contracts and in anticipation of similar follow-on contracts. For example, an electrical subcontractor installing video monitoring systems under a contract to construct a jail may do additional circuitry work on monitors in anticipation of obtaining a similar contract with the same general contractor.

Except as described below, the precontract costs, a. and b. above, may be accounted for as follows:

a. If recovery of the costs is probable, they should be recorded as deferred costs separate from the contracts in progress accounts. The deferred costs should be either:

   (1) transferred to contracts in progress when the contract is received, or

   (2) expensed to construction costs of the period when it is no longer probable that the costs will be recovered through the contract.

b. If recovery is not probable, the costs should be expensed directly to construction costs of the period. If recovery subsequently becomes probable, the costs should not be capitalized retroactively.

GAAP for construction contract accounting requires precontract costs that qualify as start-up costs to be expensed as incurred. FASB ASC 720-15-20 (formerly SOP 98-5, paragraph 5) defines start-up costs as "those one-time activities related to opening a new facility, introducing a new product or service, conducting business in a new territory, conducting business with an entirely new class of customer or beneficiary, initiating a new process in an existing facility, or commencing some new operation."

Accordingly, if precontract learning or start-up costs such as those described in item c. above, are incurred in connection with existing contracts and in anticipation of similar follow-on or future contracts, they should be charged to existing contracts. However, if the costs are not incurred in connection with existing contracts or are not incurred in anticipation of similar contracts, they should be expensed as construction costs of the period. If recovery subsequently becomes probable, the costs should not be capitalized retroactively.

Cost Adjustments Due to Back Charges. FASB ASC 605-35-25-42 (formerly SOP 81-1 at Paragraph 76) defines back charges as "work performed or costs incurred by one party that, in accordance with the agreement, should have been performed or incurred by the party to whom billed." Due to the relationship between the general contractor and the various subcontractors who assist on a project, cost adjustments often occur from back charges. For example, the general contractor may have to clean up after a subcontractor, or a subcontractor may use equipment that is owned by the general contractor. Back charges may also occur because of the relationship

between the owner and the general contractor. For example, the owner may bill the contractor for materials purchased on the contractor's behalf. Back charges should be accounted for as follows:

a. *Back Charges by the Contractor, for Example, a General Contractor's Billing to a Subcontractor for Use of the General Contractor's Equipment.*

   (1) If both the responsibility for and the amount of the charge are undisputed, the general contractor should charge them to trade receivables net of a provision for any uncollectible portion, with a credit to contracts in progress.

   (2) If either the responsibility for or the amount of the charge is disputed, they should be treated as a claim.

b. *Back Charges from Others, for Example, a Billing by the Owner for Materials Acquired on Behalf of the Contractor.*

   (1) If the probability tests of accounting for contingencies are met, the contractor should record a debit to contracts in progress and a credit to trade payables.

   (2) If the probability tests are not met, the item should be considered for disclosure following the GAAP guidelines of accounting for contingencies.

GAAP requires that the back charges be accrued when both of the following conditions exist at the balance sheet date:

a. It is probable that a liability has been incurred; and

b. The amount can be reasonably estimated.

If those two tests are not met, back charges from others should generally not be accrued. However, FASB ASC 450-10-20-50-4 (formerly SFAS No. 5) would require disclosure of the following information unless the likelihood of a liability being incurred is remote:

a. Nature of the contingency.

b. Estimate of the amount (or range) or a statement that such an estimate cannot be made.

Comparison of GAAP to Tax Cost Capitalization Rules

In general, GAAP and tax contract cost capitalization rules are the same, but tax rules tend to be more specific about the types of indirect costs that should be capitalized. For some contractors, that specificity may create situations where indirect costs capitalized for GAAP vary from those capitalized for tax.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The Codification project that replaces the GAAP hierarchy is organized into four main types of topics. Which of those four main topics includes business combinations, derivatives, and nonmonetary transactions?

   a. *Presentation (Topic Codes 205-299).*

   b. *Financial Statement Accounts (Topic Codes 305-700).*

   c. *Broad Transactions (Topic Codes 805-899).*

   d. *Industries (Topic Codes 905-999).*

2. Which of the following statements is accurate regarding the format used in the new Codification standards?

   a. The subtopics include the nature of the content of the information.

   b. The FASB Codification project not only created a new Codification, but also a new GAAP, since all changes will be put into both.

   c. New standards issued will be presented as an Accounting Standards Update.

   d. EITF Abstracts will be exempt from the new standards and are not required to include an appendix of Codification Update Instructions.

3. As related to construction contractors, which of the following accounting considerations is accurate?

   a. The percentage-of-completion (PC) method must be used to account for billings and costs.

   b. Construction-related costs, revenues, and earnings should always be reported under one profit center.

   c. Directly identifiable costs that relate specifically to a construction project to be allocated to contracts.

   d. Costs in excess of billings on contracts in progress must be recorded as liabilities.

4. The profit center for a construction company normally is which of the following?

   a. The company as a whole.

   b. Each individual contract.

5. Unless contractors have a specific requirement to the contrary, best practices indicate construction companies should submit field reports how frequently?

   a. Daily.

   b. At least weekly.

   c. Monthly.

6. A construction contractors' financial reporting system must identify and accumulate revenue, cost, gross profit, and billing information by contract due to the fact that each contract is a profit center. Construction contractors generally accomplish these using subsidiary records. According to the text, generally such records should contain all of the following information **except**:

   a. Accounts receivable records for each contract.

   b. Cost estimation worksheets and blueprints.

   c. Potential impact of one contract on other contracts.

   d. Worksheets showing how cost was determined.

7. Very few contractors use the basis of accounting known as _____ to maintain their general ledgers throughout the year.

   a. Cash basis.

   b. Accrual basis.

   c. Completed-contract.

   d. Percentage-of-completion.

8. Which of the following is an example of indirect costs normally allocated to contracts?

   a. Project construction materials.

   b. Construction labor.

   c. General construction supplies.

   d. Performance bond premiums.

9. A landscaping contractor would be **least** likely to allocate overhead based on which of the following?

   a. Direct labor hours.

   b. Direct labor costs.

   c. Material costs.

10. Which of the following statements regarding capitalization of costs under cost-plus contracts is accurate?

    a. Costs under cost-plus contracts should not be capitalized according to GAAP if they conflict with the terms of the contract.

    b. Even if they conflict with the terms of the contract, costs under cost-plus contracts should be capitalized according to GAAP.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. The Codification project that replaces the GAAP hierarchy is organized into four main types of topics. Which of those four main topics includes business combinations, derivatives, and nonmonetary transactions? **(Page 4)**

   a. *Presentation (Topic Codes 205-299).* [This answer is incorrect. The *Presentation* topic in the Codification includes income statements, balance sheets, statements of cash flow, and other presentation matters.]

   b. *Financial Statement Accounts (Topic Codes 305-700)*. [This answer is incorrect. The *Financial Statement Accounts* in the Codification topic includes assets such as receivables and inventory, liabilities, equity, revenue such as revenue recognition, and expenses.]

   c. *Broad Transactions (Topic Codes 805-899).* [This answer is correct. The *Broad Transactions* topics relate to multiple financial statement accounts and are normally transaction-oriented. Per the Codification topics include business combinations, derivatives, and nonmonetary transactions, among others.]

   d. *Industries (Topic Codes 905-999)*. [This answer is incorrect. The *Industries* topic in the Codification relates to accounting that is unique to an industry or type of activity such as airlines, software, or real estate.]

2. Which of the following statements is accurate regarding the format used in the new Codification standards? **(Page 4)**

   a. The subtopics include the nature of the content of the information. [This answer is incorrect. The nature of the content, such as recognition, measurement and disclosure is part of the sections of the new Codification, not the subtopic.]

   b. The FASB Codification project not only created a new Codification, but also a new GAAP, since all changes will be put into both. [This answer is incorrect. The FASB Codification project was designed to create a single authoritative codification of GAAP and present all of GAAP in one location. The project will not create a new GAAP.]

   c. New standards issued will be presented as an Accounting Standards Update. [This answer is correct. The Accounting Standards Update will generally be composed of a summary, amendments to the Codification, a background and basis for conclusion section, and amendments to the SBRL taxonomy.]

   d. EITF Abstracts will be exempt from the new standards and are not required to include an appendix of Codification Update Instructions. [This answer is incorrect. Regardless of the form in which such guidance may have been issued previously, EITF Abstracts are issued under the new standards and comply with the new format.]

3. As related to construction contractors, which of the following accounting considerations is accurate? **(Page 5)**

   a. The percentage-of-completion (PC) method must be used to account for billings and costs. [This answer is incorrect. The *accrual method* must be used to account for billings and costs under GAAP.]

   b. Construction-related costs, revenues, and earnings should always be reported under one profit center. [This answer is incorrect. Each contract normally represents one profit center, but not always; thus, the appropriate profit centers should always be properly identified.]

c. Directly identifiable costs that relate specifically to a construction project to be allocated to contracts. [This answer is correct. Types of costs to be allocated to contracts include directly identifiable costs that relate specifically to a construction project, indirect costs that relate to the construction process in general, and construction period interest on debt that is necessary to finance construction activity.]

d. Costs in excess of billings on contracts in progress must be recorded as liabilities. [This answer is incorrect. Costs in excess of billings on contracts in progress must be recorded as *assets*.]

4. The profit center for a construction company normally is which of the following? **(Page 6)**

a. The company as a whole. [This answer is incorrect. According to authoritative guidance, the profit center for most entities is the company as a whole, but not in the case of a construction company.]

b. Each individual contract. [This answer is correct. Unlike most entities, the profit center for a construction company is normally each individual contract per GAAP. This results from the fact that the accumulation of revenues and costs and the measurement of income varies for each construction contract.]

5. Unless contractors have a specific requirement to the contrary, best practices indicate that construction companies should submit field reports how frequently? **(Page 8)**

a. Daily. [This answer is incorrect. Unless specifically required by the contractor, the recommendation for submittal of field reports is not on a daily basis.]

b. At least weekly. [This answer is correct. Unless otherwise specified by the contractor, it is suggested the reports be submitted at least weekly.]

c. Monthly. [This answer is incorrect. Regardless of any contractor specific requirements, submittal of field reports should by accomplished more frequently than on a monthly basis.]

6. A construction contractors' financial reporting system must identify and accumulate revenue, cost, gross profit, and billing information by contract due to the fact that each contract is a profit center. Construction contractors generally accomplish these using subsidiary records. According to the text, generally such records should contain all of the following information **except**: **(Page 12)**

a. Accounts receivable records for each contract. [This answer is incorrect. In general, contractors' subsidiary records should include accounts receivable and billing records for each contract.]

b. Cost estimation worksheets and blueprints. [This answer is incorrect. Cost estimation worksheets, blueprints, plans, status reports, etc., should generally be included in a construction contractors' subsidiary report.]

c. Potential impact of one contract on other contracts. [This answer is correct. Indicating the potential impact of one contract on other contracts is not cited as information that should be included in subsidiary records of construction contractors' financial reporting systems.]

d. Worksheets showing how cost was determined. [This answer is incorrect. A construction contractors' subsidiary report generally should include worksheets indicating how periodic revenue, cost, and gross profit totals were determined.]

7. Very few contractors use the basis of accounting known as _____ to maintain their general ledgers throughout the year. **(Page 13)**

   a. Cash basis. [This answer is incorrect. Many contractors maintain their general ledgers using the same methods they use to file their tax returns, one of which might be the cash basis of accounting.]

   b. Accrual basis. [This answer is incorrect. The accrual basis of accounting is another basis of accounting that many contractors use to maintain their general ledgers.]

   c. Completed-contract. [This answer is incorrect. Contractors often use the completed-contract basis of accounting to maintain their general ledgers throughout the year.]

   d. Percentage-of–completion. [This answer is correct. Since most contractors do not maintain their general ledgers on a GAAP basis, very few contractors actually use a pure percentage-of-completion basis of accounting throughout the year.]

8. Which of the following is an example of indirect costs normally allocated to contracts? **(Page 17)**

   a. Project construction materials. [This answer is incorrect. Project construction materials are an example of direct costs due to the fact that they are normally unique to a specific contract.]

   b. Construction labor. [This answer is incorrect. Construction labor is tied directly to the contract being performed and, as such, is an example of a direct cost.]

   c. General construction supplies. [This answer is correct. General construction supplies and small tools are an example of indirect costs and should be capitalized as contract costs.]

   d. Performance bond premiums. [This answer is incorrect. Performance bond premiums can be readily identified with a specific contract and are considered direct costs.]

9. A landscaping contractor would be **least** likely to allocate overhead based on which of the following? **(Page 18)**

   a. Direct labor hours. [This answer is incorrect. Since a landscaping contractor is heavily labor intensive, allocating overhead based on direct labor hours would be very likely.]

   b. Direct labor costs. [This answer is incorrect. A landscaping contractor, which is primarily a labor-type of business, would likely allocate overhead based on direct labor costs.]

   c. Material costs. [This answer is correct. Material costs are not a principal element of a landscaping contractor's business and, therefore, allocation of overhead would be least likely based on material costs.]

10. Which of the following statements regarding capitalization of costs under cost-plus contracts is accurate? **(Page 19)**

    a. Costs under cost-plus contracts should not be capitalized according to GAAP if they conflict with the terms of the contract. [This answer is incorrect. Costs under cost-plus contracts *should* be capitalized according to GAAP *regardless of whether they conflict with the terms of the contract or not*.]

    b. Even if they conflict with the terms of the contract, costs under cost-plus contracts should be capitalized according to GAAP. [This answer is correct. The fact that costs under cost-plus contracts may conflict with contract terms does not change the fact that they should always be capitalized according to GAAP. In cases where estimated capitalized costs exceed the amounts billable, the contractor should consider establishing a reserve for loss.]

REVENUE RECOGNITION METHODS

Revenue recognition issues for construction contractors are different from those addressed by most other commercial entities. Most companies recognize revenue when inventory is delivered to a customer at the conclusion of a sale transaction. If this general rule were followed by construction contractors, revenue would not be recognized until the point of sale, which is normally the point a project is completed and delivered at the conclusion of the construction process.

However, Statement of Financial Accounting Concepts No. 5 gives the following guidance in Paragraph 84c:

> If product is contracted for before production, revenues may be recognized by a percentage-of-completion method as earned—as production takes place—provided reasonable estimates of results at completion and reliable measures of progress are available. If production is long in relation to reporting periods, such as for long-term, construction-type contracts, recognizing revenues as earned has often been deemed to result in information that is significantly more relevant and representationally faithful than information based on waiting for delivery, although at the sacrifice of some verifiability.

For GAAP purposes, two methods of recognizing revenues from construction contracts have evolved:

a. Under the percentage-of-completion (PC) method, revenues, costs, and profits are recognized in each accounting period as the contract progresses to completion.

b. Under the completed-contract (CC) method, revenues, costs, and profits are deferred until the project is substantially complete.

Note that if a company builds without a contract, all income should be recognized at the point of sale. An example of that construction type is speculative building by homebuilders.

To illustrate the concepts behind the two methods of recognizing revenue, assume the following facts:

Earnings information:	
Fixed contract price	$ 50,000
Estimated total cost of the contract	40,000
Estimated total gross profit	$ 10,000
Costs incurred to date	$ 26,000
Percent complete ($26,000 costs incurred ÷ $40,000 estimated total cost)	65 %
Progress billings collected	$ 5,000

Illustration of the Percentage-of-completion Method

Under the percentage-of-completion method, earnings of $6,500 (or 65% of the estimated total gross profit of $10,000) would be recognized. That amount would be recognized by recording proportional amounts of revenue and cost. For example, recognizing gross profit of $6,500 might require recognition of 65% of both the contract price and the estimated total costs (or $32,500 and $26,000, respectively). An asset would be established to

account for costs, billings, and accrued gross profit. The following entries would be needed for the contract illustrated in the preceding paragraph:

	DR	CR
Costs and estimated earnings in excess of billings	$ 26,000	
Cash		$ 26,000
To record costs incurred.		
Contract receivable	5,000	
Costs and estimated earnings in excess of billings		5,000
To record progress billings.		
Cash	5,000	
Contract receivable		5,000
To record collection of progress billings.		
Construction costs	26,000	
Costs and estimated earnings in excess of billings	6,500	
Construction revenues		32,500
To accrue earned gross profit.		

The following summarizes the effect of the preceding entries:

BALANCE SHEET	
Costs and estimated earnings in excess of billings	$ 27,500
INCOME STATEMENT	
Construction revenues	32,500
Construction costs	26,000
Gross profit	$ 6,500

Note that the balance sheet account equals unbilled costs plus gross profit recognized to date (or $26,000 costs incurred to date − $5,000 billings to date + $6,500 gross profit).

Illustration of the Completed-contract Method

Under the completed-contract method, the following entries would be made:

	DR	CR
Costs in excess of billings	$ 26,000	
Cash		$ 26,000
To record costs incurred.		
Contract receivable	5,000	
Costs in excess of billings		5,000
To record progress billings.		
Cash	5,000	
Contract receivable		5,000
To record collection of progress billings.		

As a result of the preceding entries, the balance sheet would report costs in excess of billings as an asset of $21,000, and there would be no income statement transactions. The asset essentially represents unrecovered costs.

The Two Methods Contrasted

The following contrasts the results under the two methods assuming the contract is completed the following year in line with the original estimates:

	% of Completion		Completed Contract	
	Year 1	Year 2	Year 1	Year 2
BALANCE SHEET				
Construction asset	$ 27,500	$ —	$ 21,000	$ —
INCOME STATEMENT				
Revenue	32,500	17,500	—	50,000
Cost	(26,000)	(14,000)	—	(40,000)
Gross profit	$ 6,500	$ 3,500	$ -0-	$ 10,000

Percentage of Completion and Completed Contract Are Not Alternatives

The two methods of accounting for construction contracts are not alternatives, that is, a contractor is not free to choose one of the two methods. Instead, the GAAP rules for accounting for long-term construction contracts specify when each method should be used. Generally, the PC method will be used except in rare circumstances.

Preferences Established by the Authoritative Literature. The preferences established by the authoritative literature are summarized as follows:

a. The PC method is preferable when *all* of the following conditions exist [FASB ASC 605-35-25-57 (formerly SOP 81-1, paragraph 23)]:

   (1) Reasonably dependable estimates can be made;

   (2) The contract clearly specifies the enforceable rights of both the contractor and the buyer, the consideration to be exchanged, and the manner and terms of settlement;

   (3) The buyer can be expected to satisfy its obligations under the contract; and

   (4) The contractor can be expected to perform its contractual obligations.

b. The CC method is preferable when *either* of the following conditions exists [FASB ASC 605-35-25-90 and 92 (formerly SOP 81-1, paragraphs 31–32)]:

   (1) The results would not vary materially from use of the percentage-of-completion method; or

   (2) Lack of dependable estimates or the existence of inherent hazards cause forecasts to be doubtful.

The use of the word *preferable* by the authoritative literature in describing which revenue recognition method should be used for construction-type contracts has often created some uncertainty. Practitioners have questioned whether the completed-contract method could be used, especially by entities that qualify as small contractors for tax purposes, thus avoiding the need to compute deferred taxes.

Best practices indicate that the use of the word *preferable* should be followed as a requirement rather than a preference. Additionally, the AICPA Audit and Accounting Guide, *Construction Contractors*, at paragraph 10.40, indicates that practitioners should be satisfied that contractors follow the guidance in FASB ASC 605-35-25-57 regarding the use of the percentage-of-completion method when the contractor meets the authoritative conditions stated. Best practices indicate that this means that contractors should always use the percentage-of-completion method unless the contractor meets either of the two conditions for use of the completed-contract method.

Criteria for Reasonably Dependable Estimates. One of the conditions for determining which revenue recognition method to select is the ability to make reasonably dependable estimates. The ability to estimate involves two separate assessments:

- The ability to make estimates in the normal course of business; and
- The ability to make estimates when there are inherent hazards related to the particular contract.

The authoritative literature assumes that the ability to make estimates in the normal course of business is essential to continuing as a going concern. Estimates are required to prepare most bids and many off-the-shelf software packages are available to assist in making estimates and tracking contract costs. The position of FASB ASC 605-35-25-58 and 66 (formerly SOP 81-1) is essentially that (a) there is a basic presumption that all construction contractors have the ability to make estimates in the normal course of business and (b) overcoming that presumption should be on a contract-by-contract basis and requires specific persuasive evidence of inherent hazards.

FASB ASC 605-35-25-65 (formerly SOP 81-1) establishes two characteristics of inherent hazards: they are unusual events that would not be considered in the ordinary preparation of contract estimates, and they would not be expected to recur frequently, given the contractor's normal business environment. Although inherent hazards should be rare, common examples might be litigation that threatens continuance of the project (for example, because of changes in zoning ordinances or suits filed because of collapses) and questions about the customer's ability to continue as a going concern.

Inherent hazards require the following special accounting considerations:

a. As previously mentioned, if inherent hazards cause forecasts to be doubtful, the completed-contract method is the preferred approach for recognizing revenue. An entity using the percentage-of-completion method as its basic accounting policy should use the completed-contract method for a single contract or a group of contracts when inherent hazards make estimates doubtful. (FASB ASC 605-35-25-61 and 25-90)

b. If reasonable dependable forecasts can be prepared and the contractor believes a loss will not be incurred on the contract, the PC method should be applied assuming a zero profit margin. (FASB ASC 605-35-25-67)

c. In some cases, when reasonably dependable estimates can be prepared, a contractor may be able to estimate total revenues or total costs in ranges of amounts. If the contractor can determine the amounts within the ranges that are most likely to occur, those amounts should be used in applying the PC method. If the most probable amounts cannot be determined, the lowest probable profit level within the ranges should be used. (FASB ASC 605-35-25-59)

Using Zero Profit Margin under the Percentage-of-Completion Method. Applying the PC method assuming a zero profit margin requires equal amounts of revenues and costs to be recognized during the construction period; therefore, the PC method differs from the CC method. To illustrate, assume that a fixed-price contract for $150,000 is obtained, and costs are expected to total $110,000. When the project is 60% complete and the contractor has progress billed $45,000, the county files suit to annex property that includes the construction site. Since the county has zoning ordinances that preclude using the property for its intended purpose and may well lead to abandonment of the project, the contractor anticipates that a settlement will ultimately be reached with the county that will at least provide for recovery of the costs already incurred. Under the PC method, since only cost recovery is expected, no profit would be recognized, and the asset would be equal to costs incurred (or $66,000). The income statement would show revenues and costs of $66,000.

If future events enable the contractor to estimate profit or loss on the contract, a cumulative catch-up adjustment would be made and accounted for as a change in estimate. The effects of the change in estimate should be reported in the period of the change and subsequent periods. Restatement of prior periods is not appropriate. For example, if, in the preceding illustration, the suit is dropped and the project is continued under its original terms, earned gross profit of $24,000 (or 60% of the $40,000 estimated total gross profit) would be accrued as a change in estimate in the year the uncertainty is resolved. In that case, all $24,000 would be recorded as revenue since costs incurred were charged in the prior year's income statement. In addition, the change in estimate should also be disclosed based on FASB ASC 250-10-50-4 (formerly paragraph 22 of SFAS No. 154, *Accounting Changes and Error Corrections*), if the effect of the change in estimate is considered material to either revenues or cost.

When Completed Contract and Percentage of Completion Are Not Materially Different. The CC method may be used if the results do not differ materially from those that would be obtained using the PC method. The following are common practice situations in which using one method may not differ materially from using the other:

a. If the yearend is typically at the down point of the business cycle, jobs in process may be small enough so that using the PC method would not materially affect earnings. In that situation, the adjustment needed to convert CC information into PC would probably not be material either to earnings or to the balance sheet.

b. If the volume and profitability of jobs in process at the beginning and end of the year are approximately the same, both the PC and CC methods might produce approximately equal earnings. In other words, the adjustment needed at the beginning and end of the year to convert CC records to PC would be approximately the same. However, in that situation, the balance sheet effect could be quite large, and the materiality of the effect on the balance sheet would need to be considered in addition to the effect on earnings.

c. If the contractor primarily performs short-term contracts during an accounting period; for example, a small plumbing contractor that generally works in the homebuilding industry.

Does the Length of the Contract Affect the Method Chosen?

No. The requirements in the authoritative literature apply to all construction contracts, regardless of length, and exceptions are justified only when the methods do not differ materially. In some situations, the methods will not differ materially for short-term contracts; but in other situations, there may be a material difference. For example, if a contractor performs primarily under contracts with relatively short terms, contracts in progress may remain at approximately the same volume and profitability at each balance sheet date so that the two methods do not differ materially. However, if substantial progress has been made on an especially large and profitable contract, the results may differ materially.

Departures from the Basic Revenue Recognition Policy

After applying GAAP requirements to decide between the PC method and the CC method, the contractor should establish a basic policy to account for construction contracts. FASB ASC 235-10-50-4 (formerly the AICPA Guide, at Paragraph 6.21, and FASB ASC 910-605-50-1 (formerly APB Opinion No. 22, *Disclosure of Accounting Policies*), require the contractor to disclose in the summary of significant accounting policies the method or methods of determining revenue and cost recognition. Contractors who use the percentage-of-completion method as their basic accounting policy should use the completed-contract method when reasonably dependable estimates cannot be made or inherent hazards make estimates unlikely. Departures from the basic policy for a single contract or a group of contracts should be disclosed.

Deciding Which Method to Use for Interim Financial Reporting

FASB ASC 270-10-45-2 (formerly APB Opinion No. 28) requires using the same accounting principles in both interim and annual financial statements. Therefore, if a contractor uses the PC method in its annual statements, using the CC method in its interim statements would be a departure from GAAP and any accountant who compiled, reviewed, or audited the interim statements would be required to issue a modified report in those circumstances. However, because converting is costly, the client may view the departure as a cost-effective alternative for the interim statements. In that case, a note such as the following would be presented in the summary of significant accounting policies in the interim statements:

> Revenue and Cost Recognition
>
> In the Company's annual financial statements, construction revenues and costs are recognized using the percentage-of-completion method and, accordingly, are reported in earnings as construction progresses. Applying that method requires estimates and computations for each contract that management believes are not practical for interim presentations. Accordingly, in the accompanying interim financial statements, construction revenues and costs are recognized using the completed-contract method.

Under the completed-contract method, direct material and labor costs and indirect costs related to contract performance are capitalized, and contract revenues and capitalized costs are recognized in earnings when the customer accepts the work.

Estimating Contract Costs and Revenues

A critical part of the percentage-of-completion computation is the estimation of costs to complete the project and the estimation of total contract revenue. These estimations are also crucial in determining the need for a provision for anticipated losses.

Estimated Costs to Complete. FASB ASC 605-35-25-44 (formerly Paragraph 78 in SOP 81-1) provides the following guidelines for estimating costs to complete a project:

a. The accounting records should provide a basis for periodically comparing actual and estimated costs.

b. In estimating total contract costs, the quantities and prices of all significant cost elements should be identified.

c. The estimating procedures should ensure that estimated cost to complete includes the same elements of cost that are included in actual accumulated costs; also, those elements should reflect expected price increases.

d. The effects of future wage and price escalations should be taken into account in cost estimates when the length of the contract makes such factors material.

e. Estimates of cost to complete should be reviewed periodically and revised as appropriate to reflect new information.

Estimating costs to complete may involve either forecasting or projecting additional costs or reviewing original estimates to determine whether revisions are needed. For example, if, after reviewing and considering any new information (including costs to date), the contractor believes the contract is progressing in line with the original estimates, it may be appropriate to determine estimated costs to complete as the difference between the original cost estimates less costs incurred. Similarly, if the original cost estimates are believed to be understated by approximately $20,000, the same computation could be made and $20,000 added to estimated costs to complete.

Estimated costs to complete also should include liquidated damages that have been incurred and any other liquidated damages expected to be paid. The contractor should also consider whether the estimated liquidated damages cause the contract to go into a loss position. Finally, the contractor should understand the reason for the liquidated damages and determine whether there will be a claim made by the contractor against the owner.

It is critical that costs incurred and estimated costs to complete include the same components of contract costs. For example, if costs incurred include overhead allocation and capitalized interest, but total cost estimates do not, recognized profit will be overstated during that period and understated during subsequent periods.

Estimated Total Contract Revenues. Estimating contract revenues involves consideration of (a) the basic contract price, (b) change orders, (c) options and additions, and (d) claims.

Basic Contract Price. Determining the basic contract price varies according to the type of contract. FASB ASC 605-35-20 (formerly Appendix B of SOP 81-1) lists several types of contracts used by construction contractors.

To estimate contract revenues, all clauses in the contract that might affect revenues ultimately generated must be considered. Fixed-price contracts (which are also known as lump-sum contracts) with no provision for adjustment pose no problems in estimating contract revenues because the fixed price is the total revenue expected from the job. However, other types of contracts require judgment in estimating contract revenues. For example, for cost-plus-incentive-fee contracts with incentives based on cost, allowable costs must be estimated; this may entail interpreting which costs are allowable. The accuracy of the estimate also varies with the contract's length; for example, early estimates in a three-year contract with target cost incentives would require more subsequent

revisions than a one-year contract with those same incentives. Similarly, the accuracy of the estimates will improve as the contract progresses because management's performance in comparison with performance incentives will become clearer. But difficulty in estimating and the imprecision of the estimate do not change the selection of the basic accounting method (percentage-of-completion or completed-contract) or its application. Estimates should preferably be single point estimates, but estimates in ranges are acceptable alternatives if single point estimates are not reasonably determinable.

As a general rule, estimated contract revenues should include all items for which the contractor has risk or that were included in determining the project fee. Therefore, if the contractor requests the customer to purchase materials to the contractor's specifications (for example, because of the customer's leverage with suppliers), the cost of those materials should be included in the estimated revenues. On the other hand, if the contractor uses some of the customer's employees to help with the construction under a cost-type contract and the employees are paid by the customer, the contractor would not include those labor costs in the computation of revenues as reimbursable costs. Therefore, any cost-based fee would not consider those because the contractor has no risk.

Change Orders. Change orders modify provisions of the original contract but do not add new provisions. Any aspect of a contract, such as specifications or design, the method or manner of performance, the site, or the construction period, could be the subject of a change order. A change order could be initiated either by the contractor or the customer.

Some change orders generate no additional revenues (such as when the initial contract provides that specified changes can be made at no charge, and therefore, require no consideration in estimating contract revenues). However, others generate additional revenues and require consideration in the estimate. Including the price of a change order in estimated contract revenues depends on whether it has been priced and whether the price and scope have been approved. For example:

a. If a change order is priced and both parties have approved the scope and price, estimated contract revenues would include the price of the change order.

b. If a change order is unpriced but both parties have approved the scope, treatment varies with the accounting method.

c. If a change order is priced but the parties have not approved the price or the scope, it would be evaluated as a claim.

The following summarizes the accounting treatment for change orders that are unpriced but for which the scope has been approved:

Percentage-of-completion method

a. If it is probable that the costs of the change order will be recovered by changing the contract price, the costs should be charged to contracts in progress, and either of the following is acceptable:

   (1) Recognize none of the costs in the income statement until pricing has been approved; or

   (2) Recognize costs incurred and equal amounts of revenue in the income statement.

b. If it is probable that the change order will generate additional gross profit, it should be recognized prior to pricing only if realization is assured beyond a reasonable doubt.

c. Any portion of the contract costs, including change orders, for which recovery is not probable (which may be all of the cost of the change order or only a portion of it) should be charged to current operations.

Completed-contract method

d. If it is probable that the contract cost, including change orders, will be recovered, the cost of the change order should be included in contracts in progress.

e. Any portion of the contract cost, including change orders, for which recovery is not probable (which may be all of the cost of the change order or only a portion of it) should be charged to current operations.

Options and Additions. An option or addition to a basic contract adds a provision to the original contract. For example, if a customer changed the layout of an office building, the change would be accounted for as a change order. However, if a customer originally contracted for building a plant but decided to add a wing to the original structure, the change would probably be accounted for as an addition.

Deciding whether to include the option or addition in estimated contract revenues first requires assessing whether the change is, in substance, a new contract. FASB ASC 605-35-25-29 (formerly Paragraph 64 in SOP 81-1) requires treating options or additions to an existing contract as a separate contract in *any* of the following circumstances:

a. The product or service to be provided differs significantly from the product or service provided under the original contract.

b. The price of the new product or service is negotiated without regard to the original contract and involves different economic judgments.

c. The products or services to be provided under the exercised option or addition are similar to those under the original contract, but the contract price and anticipated contract cost relationship are significantly different.

An option or addition should be accounted for as follows:

a. If it meets the criteria for a new contract and the criteria for combining, it should be combined with the original contract. The price of the option or addition would be added to the basic contract price in estimating contract revenues.

b. If it meets the criteria for a new contract but not the criteria for combining, it should be treated as a separate contract. The price of the option or addition would be the estimated contract revenues for the profit center.

c. If it does not meet the criteria for a new contract, it should be treated as a change order.

Claims Made by the Contractor against the Owner. Claims made by the contractor against the owner are attempts by the contractor to collect additional revenues, typically because of unforeseen circumstances the contractor could not have avoided. Common reasons for claims listed in FASB ASC 605-35-25-30 (formerly SOP 81-1) include owner-caused delays, errors in specifications and designs, contract terminations, and unapproved or disputed change orders. When claims are made against the owner, GAAP permits either including the claim in revenues in the period it is made under certain specified conditions (which is an accrual approach) or only recording revenue from claims when awarded (which is a cash approach). The authoritative literature indicates that the alternatives are equally acceptable, so the contractor may elect either one. Although consistency is not addressed, the authors recommend adopting a basic policy and applying it to all claims, even when there is an anticipated contract loss.

FASB ASC 605-35-25-31 (formerly SOP 81-1) allows claims made by the contractor against the owner to be included in contract revenues to the extent contract costs relating to the claims have been incurred if *all* of the following conditions exist:

a. The contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained stating that under the circumstances there is a reasonable basis to support the claim. If legal proceedings have concluded favoring the contractor, most likely the test has been met. Even if appeals are expected, the initial opinion may be enough to support revenue recognition. If legal proceedings are not complete, the contractor should obtain representation from counsel that there is a reasonable basis for the claim. If a reasonable basis for the claim does not exist, it is unnecessary to go any further.

b. Additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance. To identify those situations, the company needs to

be very aware of the specific terms, specifications, and conditions of the contract. That knowledge will assist in quickly identifying the areas requiring contract modification.

c. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed. Answers to the following questions might help in evaluating this condition:

   (1) Is the contractor's job cost system set up to identify the cost?

   (2) If the cost system cannot identify the cost, can the work be segregated from other contract work and reliable estimates be prepared?

   (3) Would another contractor doing the same job likely have incurred similar costs?

   The contractor has an obligation to keep the additional costs to a minimum. The general terms of many contracts require contractors to proceed in an efficient and timely manner.

d. The evidence supporting the claim is objective and verifiable and not based on management's *feel* for the situation or on unsupported representations. The absence of a summarized, quantified claim usually would prevent passing this test. Claim proceedings will require documents and schedules to be prepared and possibly audited by opposing counsel's accountants.

If some but not all of these conditions are met, the claim is a contingent gain, and FASB ASC 450-30-25-1 (formerly SFAS No. 5, Paragraph 17), prohibits recording those gains before realization.

If all of the preceding conditions are met, revenue recognition is limited to costs recognized under the particular contract accounting method (percentage-of-completion or completed-contract). In addition, special disclosures are required.

Provision for Anticipated Losses

Regardless of the revenue recognition method used by a contractor, GAAP requires the accrual of a loss provision whenever it becomes apparent that the total estimated contract cost will materially exceed the contract revenue or price. To determine if an anticipated loss exists, the following factors must be assessed for each contract in progress at year end:

a. Costs incurred to date.

b. Estimated costs to complete.

c. Estimated total contract revenues.

In essence, a loss provision should be recorded on a contract if the total of costs incurred to date plus estimated costs to complete exceed the estimated total contract revenues. The components that should be included in costs incurred to date are discussed in the preceding paragraphs. The estimated cost to complete and estimated total revenues are discussed earlier in this lesson.

Accrual of Anticipated Losses. If, after comparing the estimated total contract revenue to the costs incurred to date plus the estimated costs to complete, a loss is expected on a particular contract, the loss should be charged to a special loss account. The required entry will debit a special loss account, such as *Provision for Losses on Contracts in Progress*, with a corresponding credit to an accrued liability, such as *Accrued Losses on Contracts in Progress*. Regardless of the revenue recognition method used by the contractor, the contractor should ensure that—

a. the loss is included in contract costs for the period, and the accrued liability should be disclosed separately in the balance sheet, if material, and

b. the accrual is reversed against contract costs when the project is substantially complete.

Revenue and Cost Recognition Issues Involving Loss Contracts. As previously discussed, losses must be accrued during the period they become known regardless of the revenue recognition method used. However, the recognition of revenues and costs incurred differs under the two revenue recognition methods as follows:

a. Under the percentage-of-completion method, the loss would be recognized in the period determined, and revenues would be recorded based on the percentage of completion.

b. Under the completed-contract method, the loss would still be recorded in the period it is determined, but no revenues related to the contract would be recognized and costs would be deferred. As with profitable contracts, contract revenues would be recorded during the period of substantial completion, and related costs would be charged against them in that period.

Illustration Involving a Loss Contract. Regardless of the revenue recognition method used, the total anticipated loss on a given contract would be accrued in the period it is determined, with no profit or loss to be reported during future periods (unless the estimated amount of the anticipated loss changes during future periods). To illustrate, assume that a fixed-price contract for $100,000 that was originally expected to cost $80,000 has incurred actual costs of $32,000, prior to any loss accrual. At the balance sheet date (end of Year 1), the contractor believes that cost overruns will be $40,000 resulting in a loss of $20,000. Progress billings of $30,000 had been made as of the end of Year 1. Thus, at the end of Year 1, the cost-to-cost percentage of completion is 26.67% ($32,000 ÷ $120,000). The following compares the accounting treatment under the percentage-of-completion and the completed-contract methods:

	% of Completion		Completed Contract	
	Year 1	Year 2	Year 1	Year 2
Revenues	$ 26,667	$ 73,333	$ —	$ 100,000
Costs incurred	32,000	88,000	—	120,000
Accrued loss (reversal)	14,667	(14,667)	20,000	(20,000)
	46,667	73,333	20,000	100,000
Gross profit (loss)	$ (20,000)	$ -0-	$ (20,000)	$ -0-

The following journal entries would be needed for this contract using the percentage-of-completion method:

Year 1

	DR	CR
(1) Costs and estimated earnings in excess of billings	$ 32,000	
Cash		$ 32,000
To record costs incurred.		
(2) Contract receivable	30,000	
Costs and estimated earnings in excess of billings		30,000
To record progress billings.		
(3) Cash	30,000	
Contract receivable		30,000
To record collection of progress billings.		
(4) Provision for losses on contracts in progress	14,667	
Accrued losses on contracts in progress		14,667
To record estimated loss.		
(5) Construction costs	32,000	
Contract revenues ($100,000 × 26.67%)		26,667
Costs and estimated earnings in excess of billings		5,333
To record costs and revenues to date.		

Year 2

	DR	CR
Costs and estimated earnings in excess of billings	$ 73,333	
Accrued losses on contracts in progress	14,667	
Cash		$ 88,000
To record costs incurred and reverse accrued loss.		
Contract receivable	70,000	
Costs and estimated earnings in excess of billings		70,000
To record progress billings.		
Cash	70,000	
Contract receivable		70,000
To record collection of progress billings.		
Construction costs	73,333	
Construction revenues		73,333
To record costs and revenues in Year 2.		

Revenue Recognition—Joint Project of the FASB and IASB

The FASB and the IASB have been working together to draft a new revenue recognition standard that would clarify the principles for recognizing revenue and develop a common revenue standard for U.S. GAAP and the International Financial Reporting Standards (IFRS). In December 2008, the two Boards issued a discussion paper, *Preliminary Views on Revenue Recognition in Contracts with Customers*, which was available for public comment until mid-June 2009. The discussion paper includes an appendix highlighting how the anticipated proposed standard will affect construction contractors. The discussion paper is still available on the FASB's website at **www.fasb.org/draft/DP_Revenue_Recognition.pdf**.

The anticipated proposed revenue recognition standard is expected to significantly affect construction contractors, as well as other industries. For example, it is expected to eliminate the recognition of estimated revenues during the contract term (unless specific criteria are met for continuous transfer of assets) and instead recognize revenue when goods and services are transferred to the customer and costs are incurred (unless eligible for capitalization under other standards). The FASB currently indicates that an exposure draft will be issued in the second quarter of 2010. Practitioners will want to be alert to the issuance of this exposure draft. The revenue recognition project can be monitored from the FASB's website at **www.fasb.org** (click on the "Projects" link).

THE PERCENTAGE-OF-COMPLETION METHOD

As previously discussed, the percentage-of-completion method should be used to account for substantially all contracts in progress at a specific point in time. There are certain alternative approaches that may be used in applying this method and they are discussed in this section. Specifically, the accounting considerations that will be discussed are as follows:

a. Determining the percentage of completion.

b. Two alternative approaches to determining revenues and costs to be recognized.

Determining the Percentage of Completion

FASB ASC 605-35-25-51 and 52 (formerly Paragraph 4 of ARB No. 45) give the following guidance related to determining the extent of progress toward completion of a contract in progress:

a. Recognized income (under the percentage-of-completion method) shall be that percentage of estimated total income, either:

   (1) that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information, or

(2) that may be indicated by such other measure of progress toward completion as may be appropriate having due regard to work performed.

In practice, many methods are used, but all can be grouped into the following two classifications:

a. *Input methods* base the percentage of completion on efforts devoted to a contract. One of the most common bases is contract costs, which is the method described at item (1) above, but other methods such as engineering estimates and direct labor hours also are acceptable.

b. *Output methods* base the percentage of completion on results achieved. A common basis is preestablished milestones. For example, the contract will be 10% complete after the foundation is dug and footings poured and 45% complete after the building is under roof; but, other methods such as yards of concrete poured and units produced also are acceptable.

Cost-to-cost Method. One widely used method of determining the percentage of completion is the *cost-to-cost* method, whereby costs incurred to date are compared to the estimated total costs to be incurred. The percentage of completion is calculated by dividing the costs incurred to date (the numerator) by the estimated total costs to be incurred for a contract (the denominator). For example, if $12,000 of costs have been incurred on a contract with an estimated total cost of $30,000, the contract is 40% complete using the cost-to-cost method. Although this method seems to be fairly easy to apply, the following factors should be kept in mind when the cost-to-cost method is used:

a. The cost-to-cost calculation of percentage of completion should not be performed until all costs have been accrued. Before applying this method, the accountant should identify and correct all cost accumulation errors. For example, the ledgers may be on a cash rather than accrual basis, overhead costs may have been expensed rather than properly allocated to the contracts in progress during the period, or construction period interest may not have been properly capitalized. It is impossible to accurately assess the extent of progress toward completion using the cost-to-cost method unless all costs are included in the numerator of the calculation.

b. The estimate of total costs to be incurred on a project must also be complete and accurate. Some contractors routinely divide the costs incurred to date by the original cost estimate, even though it may no longer be appropriate. Since the estimate of total job costs will be the denominator in the percentage-of-completion calculation, the resulting percentage will be reliable only if the estimate of total costs is recalculated at each balance sheet date using all of the appropriate factors.

c. Costs that do not relate to contract performance should be disregarded in applying the cost-to-cost method. Costs incurred to date (the numerator) should normally be reduced by the cost of uninstalled materials, unless those materials have been specifically produced, fabricated, or constructed for a project.

Uninstalled Materials. In using the cost-to-cost method, the contractor is attempting to obtain an accurate estimate of the extent of contract performance to date. Because uninstalled materials do not generally relate to job performance, the cost of those materials that are not unique to the project should be excluded from actual costs incurred to date in applying the cost-to-cost method. This does not mean that all uninstalled materials should be omitted from the percentage-of-completion calculation. FASB ASC 605-35-25-76 (formerly SOP 81-1, Paragraph 50, footnote 9), provides the following guidance regarding the types of uninstalled materials that should be included in the calculation:

> The cost of uninstalled materials specifically produced, fabricated, or constructed for a project should be included in the costs used to measure extent of progress. Such materials consist of items unique to a project that a manufacturer or supplier does not carry in inventory and that must be produced or altered to meet the specifications of the project.

For example, assume a drywall contractor has the following contract:

Total contract price	$ 112,000
Total estimated costs	92,000
Estimated gross profit	$ 20,000

If actual costs incurred at the contractor's year end are $38,640, the contract is 42% complete ($38,640 ÷ $92,000) using the cost-to-cost method, and the gross profit that would be recognized at that date would be 42% × $20,000, or $8,400. The direct materials included in the $38,640 of costs incurred to date should include all materials already installed, but should generally omit all uninstalled materials.

a. Sheetrock and other direct materials used by drywall contractors are common materials used in the construction of most buildings and thus would not be included in contract costs until they are installed.

b. However, certain moldings and other materials might have been fabricated for the specific project and should be included in contract costs even if they have not yet been installed.

To illustrate this distinction, assume that the $38,640 of costs incurred to date in the previous example includes the following components:

Sheetrock and other common materials delivered to the job site	$ 25,600
Unique materials fabricated for the project	4,540
Direct labor	5,500
Other costs	3,000
Total	$ 38,640

If only $3,520 of the sheetrock and other common materials had been installed as of the balance sheet date, the cost of uninstalled common materials ($25,600 − $3,520 = $22,080 in this example) should be subtracted from the estimate of costs incurred to date. This would lower the estimate of costs incurred as of the balance sheet date from $38,640 to $16,560. The following analysis illustrates the effect of the adjustment of costs incurred to date for uninstalled materials:

	Before Adjustment	After Adjustment
Costs incurred to date	$ 38,640	$ 16,560
Percentage complete	42%	18%
Revenues	$ 47,040	$ 20,160
Cumulative profit	8,400	3,600

It is clear from the preceding illustration that the proper exclusion of uninstalled materials can have a very significant impact on the revenues, costs, and profits recognized under the percentage-of-completion method for contracts in progress at a given balance sheet date. Not only can the adjustment of percentage completion for uninstalled materials be significant, it usually leads to a temporary difference because tax law requires that such materials be included in the cost-to-cost determination.

Conclusion Regarding the Determination of Percentage of Completion. Selecting the method or methods of measuring the extent of progress toward completion involves a great deal of judgment. GAAP does not require the use of a particular method; however, the method selected for a particular type of contract should be representative of performance. The method or methods selected should also be applied consistently to all contracts having similar characteristics. Since the methods used by a company will have a direct impact on the amount of revenues, costs, and profits recognized on contracts in progress, great care should be exercised in selecting the appropriate methods and in applying them at each balance sheet date.

Determining Revenues and Costs to Be Recognized

After the percentage of completion of a particular contract has been determined, the next step is to use this percentage in calculating the amount of revenues, costs, and profits to be recognized. FASB ASC 605-35-25-82 through 84 (formerly SOP 81-1) provides two methods for recognizing revenues, costs, and profits:

a. *Alternative A* applies the percentage of completion to total estimated contract revenue and total estimated contract costs. Gross profit recognized is the difference between the two products.

b. *Alternative B* applies the percentage of completion to total estimated gross profit from the contract, and the profit is added to costs incurred to determine revenues recognized.

Both methods produce the same gross profit, that is, total estimated gross profit times the percentage of completion, but do not always produce the same revenues and costs. If the percentage of completion is determined based on the relationship of costs incurred to estimated total costs, both methods produce the same results. To illustrate, assume that costs of $120,000 have been incurred on a fixed-price contract for $200,000 expected to yield gross profit of $40,000. Total estimated contract costs are $160,000. Using the cost-to-cost approach, the percentage of completion is 75% (or $120,000 ÷ $160,000). Revenue and cost to be recognized under the two methods would be as follows:

Alternative A	
Revenues (75% of the $200,000 total contract revenues)	$ 150,000
Costs (75% of the $160,000 total contract costs)	(120,000)
Gross profit	$ 30,000
Alternative B	
Gross profit (75% of the $40,000 total contract gross profit)	$ 30,000
Costs incurred	120,000
Revenues	$ 150,000

But different answers would be obtained if other methods were used to compute the percentage of completion. To illustrate, assume that the percentage of completion is 60% based on direct labor hours:

Alternative A	
Revenues (60% of the $200,000 total contract revenues)	$ 120,000
Costs (60% of the $160,000 total contract costs)	(96,000)
Gross profit	$ 24,000
Alternative B	
Gross profit (60% of the $40,000 total contract gross profit)	$ 24,000
Costs incurred	120,000
Revenues	$ 144,000

A contractor may use either of the preceding methods, and best practices indicate that one method be selected and applied to all contracts. Under either method, the computations are on a cumulative basis, and amounts recognized in prior periods are subtracted to determine current period amounts. The effects of revisions to the estimates are thus recorded in the period the revisions are determined, and prior periods are not changed. The balance sheets are the same regardless of the alternative used because costs incurred, gross profit recognized, and progress billings are the same.

THE COMPLETED-CONTRACT METHOD

As previously noted, the percentage-of-completion method must be used by most contractors, and the completed-contract method will normally not be encountered. Although the CC method is much easier to apply than the PC method, there are two issues that must be addressed in those rare instances when it is used:

a. Determining the point of substantial completion is critical because it determines when all profit is recognized.

b. The allocation of general and administrative expenses to contracts rather than to periodic income may be appropriate in certain circumstances.

Determining the Point of Substantial Completion

Determining the point of substantial completion is critical to the CC method because it determines when all profit is recognized. The following guidelines have been summarized from FASB ASC 605-35-25-96 and 605-350-50-4 (formerly SOP 81-1):

a. As a general rule, the point is reached when remaining costs and potential risks are insignificant.

b. Use consistent criteria for determining substantial completion and avoid arbitrary acceleration or deferral of income.

c. Disclose the criteria in the summary of significant accounting policies.

Examples of common criteria are final acceptance by the customer and acceptance subject to completion of a "punch list." Also, standard percentages may be used as guidelines. For example, if a job is 95% complete, many contractors view it as complete.

Capitalization of General and Administrative Expenses

General and administrative (G&A) expenses would never be capitalized under the PC method. However, because most construction contracts are long-term in nature, it may sometimes be appropriate to capitalize G&A costs into contracts if the CC method is used. FASB ASC 605-35-25-99 (formerly ARB No. 45) allows the allocation of G&A costs to contracts rather than to periodic income if a better matching of costs and revenues would result, particularly in years when no contracts are completed. It is believed that capitalization of G&A costs will be rare.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. For purposes of GAAP, there are two methods of recognizing revenues from construction contracts. Which method specified in ARB No. 45 and SOP 81-1 is used in most construction contracts?

    a. The percentage-of-completion (PC) method.

    b. The completed-contract (CC) method.

12. Bill Webb Construction Co. has determined that use of the CC method is indicated due to which of the following considerations?

    a. The contractor can determine total revenues or total costs within the ranges most likely to occur.

    b. The contractor is unable to determine that a loss will not be incurred.

    c. The contractor believes a loss will not be incurred on the contract.

    d. The contractor believes a loss is likely and all of the expected loss should be accrued.

13. Change orders can be issued to accomplish any of the following **except**:

    a. Add new contract provisions.

    b. Modify specifications or design.

    c. Alter the method of performance.

    d. Revise the construction period.

14. ABC Construction is attempting to decide whether to include the price of a change order in estimated contract revenues. In which of the following circumstances would ABC Construction decide that a change order should be evaluated as a claim?

    a. If a change order is priced and both parties have approved the scope and price.

    b. If a change order is priced but the parties have not approved the price or the scope.

    c. If a change order is unpriced but both parties have approved the scope.

15. An option or addition should be treated as a change order in which of the following scenarios?

    a. It meets the criteria for a new contract and the criteria for combining.

    b. It does not meet the criteria for a new contract.

    c. It meets the criteria for a new contract but not the criteria for combining.

16. When the total estimated contract cost is expected to materially exceed the contract revenue or price, it is necessary to determine if an anticipated loss exists. This is done by assessing several factors for each contract in progress at year end. Which of the following factors would **not** be useful in determining if an anticipated loss exists?

    a. Pre-contract cost estimates.

    b. Costs incurred to date.

    c. Estimated costs to complete.

17. Using the "cost-to-cost" method of determining the percentage of completion of a contract, what percent of the contract is complete if $28,000 of costs has been incurred on a contract with an estimated total cost of $160,000?

    a. 16.9%.

    b. 17.5%.

    c. 18.4%.

    d. 19.1%.

18. Which of the following contractor materials should be included in actual costs incurred to date in applying the cost-to-cost method?

    a. Sheetrock and other direct materials that have not yet been installed.

    b. Unique materials fabricated for the project that have not yet been installed.

    c. Roofing shingles that have not been installed.

    d. Electrical wiring that has not yet been installed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. For purposes of GAAP, there are two methods of recognizing revenues from construction contracts. Which method specified in ARB No. 45 and SOP 81-1 is used in most construction contracts? **(Page 28)**

    a. The percentage-of-completion (PC) method. [This answer is correct. Since construction contracts can last for extended periods of time, the PC Method allows the recognition of revenues, costs, and profits in each accounting period as the contract progresses to completion.]

    b. The completed-contract (CC) method. [This answer is incorrect. Using the CC method would mean that revenues, costs, and profits would be deferred until the project is substantially complete, which could be a protracted period of time.]

12. Bill Webb Construction Co. has determined that use of the CC method is indicated due to which of the following considerations? **(Page 31)**

    a. The contractor can determine total revenues or total costs within the ranges most likely to occur. [This answer is incorrect. If the contractor can determine total revenues or total costs within the ranges most likely to occur, those amounts should be used in applying the PC method. In cases where the most probable amounts cannot be determined, the lowest probable profit level within the ranges should be used.]

    b. The contractor is unable to determine that a loss will not be incurred. [This answer is correct. If the contractor cannot determine that a loss will not be incurred, the CC method should be used. It should be noted that this is the only suggested use of the CC method.]

    c. The contractor believes a loss will not be incurred on the contract. [This answer is incorrect. If the contractor believes a loss will not be incurred on the contract, the PC method should be applied assuming a zero profit margin.]

    d. The contractor believes a loss is likely and all of the expected loss should be accrued. [This answer is incorrect. If the contractor believes a loss is probable, all of the expected loss should be accrued, and the PC method should be applied.]

13. Change orders can be issued to accomplish any of the following **except**: **(Page 34)**

    a. Add new contract provisions. [This answer is correct. Options and additions add provisions to original contracts. Change orders do not add any new provisions to contracts.]

    b. Modify specifications or design. [This answer is incorrect. According to SOP 81-1, change orders can modify a variety of provisions of the original contract, one being the modification of specifications or design.]

    c. Alter the method of performance. [This answer is incorrect. According to SOP 81-1, altering the method of performance can be accomplished by using contract change orders.]

    d. Revise the construction period. [This answer is incorrect. According to SOP 81-1, contract change orders are an appropriate means to revise the construction period of the original contract.]

14. ABC Construction is attempting to decide whether to include the price of a change order in estimated contract revenues. In which of the following circumstances would ABC Construction decide that a change order should be evaluated as a claim? **(Page 34)**

    a. If a change order is priced and both parties have approved the scope and price. [This answer is incorrect. If a change order is priced and both parties have approved the scope and price, estimated contract revenues would include the price of the change order.]

    b. If a change order is priced but the parties have not approved the price or the scope. [This answer is correct. A change order would be evaluated as a claim if it is priced but the parties have not approved the price or the scope.]

    c. If a change order is unpriced but both parties have approved the scope. [This answer is incorrect. If a change is unpriced but both parties have approved the scope, treatment varies with the accounting method being used.]

15. An option or addition should be treated as a change order in which of the following scenarios? **(Page 35)**

    a. It meets the criteria for a new contract and the criteria for combining. [This answer is incorrect. An option or addition should be combined with the original contract if it meets the criteria for a new contract and the criteria for combining.]

    b. It does not meet the criteria for a new contract. [This answer is correct. If an option or addition does not meet the criteria for a new contract, it should be treated as a change order.]

    c. It meets the criteria for a new contract but not the criteria for combining. [This answer is incorrect. An option or addition should be treated as a separate contract if it meets the criteria for a new contract but not the criteria for combining as stated in FASB ASC 605-35-25-30 (formerly SOP 81-1, paragraph 64).]

16. When the total estimated contract cost is expected to materially exceed the contract revenue or price, it is necessary to determine if an anticipated loss exists. This is done by assessing several factors for each contract in progress at year end. Which of the following factors would **not** be useful in determining if an anticipated loss exists? **(Page 36)**

    a. Pre-contract cost estimates. [This answer is correct. Pre-contract cost estimates are estimates that are made prior to contract authorization, and have no bearing on any calculation as to whether an anticipated loss exists on a contract in progress at year end.]

    b. Costs incurred to date. [This answer is incorrect. Costs incurred to date are one of several factors that must be assessed in order to determine if an anticipated loss exists.]

    c. Estimated costs to complete. [This answer is incorrect. Estimated costs to complete have a direct bearing on determining whether the total estimated contract cost is expected to materially exceed the contract revenue or price which would determine if an anticipated loss exists.]

17. Using the "cost-to-cost" method of determining the percentage of completion of a contract, what percent of the contract is complete if $28,000 of costs has been incurred on a contract with an estimated total cost of $160,000? **(Page 39)**

    a. 16.9%. [This answer is incorrect. 16.9% of the contract would be complete if $28,000 of costs has been incurred on a contract with an estimated total cost of $166,000 using the cost-to-cost method.]

    b. 17.5%. [This answer is correct. A contract with $28,000 of costs already incurred and total estimated cost of $160,000, is 17.5% complete using the cost-to-cost method.]

    c. 18.4%. [This answer is incorrect. 18.4% of the contract would be complete if $28,000 of costs has been incurred on a contract with an estimated total cost of $152,000 using the cost-to-cost method.]

    d. 19.1%. [This answer is incorrect. A contract with an estimated total cost of $146,000 and $28,000 of costs has been incurred would be 19.1% complete using the cost-to-cost method.]

18. Which of the following contractor materials should be included in actual costs incurred to date in applying the cost-to-cost method? **(Page 39)**

    a. Sheetrock and other direct materials that have not yet been installed. [This answer is incorrect. Since materials such as sheetrock are common materials used in most building construction, they would not be included in contract costs when applying the cost-to-cost method until they are installed.]

    b. Unique materials fabricated for the project that have not yet been installed. [This answer is correct. Since unique materials have been fabricated specifically for a particular project, FASB ASC 605-35-25-76 states that they should be included in contract costs when applying the cost-to-cost method even if they have not yet been installed.]

    c. Roofing shingles that have not yet been installed. [This answer is incorrect. Since roofing shingles are common building materials used in most building constructions, they would not be included in contract costs when applying the cost-to-cost method until they are installed.]

    d. Electrical wiring that has not yet been installed. [This answer is incorrect. Electrical wiring is a common building material used in virtually all building construction and, thus, would not be included in contract costs when applying the cost-to-cost method until they are installed.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (CONTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Which of the following statements accurately describes *The FASB Accounting Standards Codification*, SFAS No. 168?

   a. The FASB Accounting Standards Codification is effective for financial statements issued for annual periods ending after September 1, 2009.

   b. SFAS No. 168 decreased the GAAP hierarchy from four levels of two.

   c. The Codification guidance is based on a hierarchical basis.

   d. SFAS No. 168 no longer includes SEC guidance applicable only to SEC registrants.

2. Under GAAP, when the contractor can overcome the basic presumption that it has the ability to make reasonably dependable estimates using persuasive evidence, which method of recognizing revenue on construction contracts should be used?

   a. The percentage-of-completion (PC) method.

   b. The completed-contract (CC) method.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

3. The contractor normally exercises significant influence over a venture when the ownership percentage is between which of the following?

   a. 15% and 30%.

   b. 20% and 40%.

   c. 20% and 50%.

   d. 25% and 50%.

4. As indicated in SOP 81-1 (FASB ASC 605-35-25-8), a group of contracts may be combined for accounting purposes if a number of contract circumstances are met. Which of the following does **not** accurately describe one of those required circumstances?

   a. The contracts are negotiated in a common economic environment as a group with an overall profit margin objective.

   b. The contracts constitute an agreement with at least three customers.

   c. The contracts form an agreement to perform a single project.

   d. The contracts are performed at the same time or in an uninterrupted sequence under common project management at the same location, or at least in the same general area.

5. Which of the following is **not** specifically identified as information to consider including in the field report submitted by construction companies?

   a. Estimates of additional personnel needed.

   b. Employee terminations and resignations.

   c. Description of injuries during the period.

   d. Narrative description of job progress.

6. Of the items listed on the field report, which one may be unnecessary in certain situations?

   a. Employee resignations.

   b. Description of job progress.

   c. Daily weather information.

   d. Change orders received.

7. According to the text, contractors use a number of methods to record contract activity. Which of the following is **not** identified as being one of the more commonly used methods?

   a. The construction-in-progress approach.

   b. The direct P&L approach.

   c. The indirect P&L approach.

   d. Do not select this answer choice.

8. Which of the following is an example of direct costs?

   a. Storage buildings.

   b. Assembly plants.

   c. Fringe benefits.

   d. Subcontractor charges.

9. Company XYZ has a total overhead amount of $35,000. Contract A has $60,000 in direct labor costs, Contract B has $5,000 in direct labor costs, and Contract C has $60,000 in direct labor costs. How much allocated overhead should be applied to Contract B?

   a. $1,250.

   b. $1,400.

   c. $1,650.

   d. $1,800.

10. Bulkhead Construction Company wants to determine the equipment variance for its equipment cost pool. The total credit to its cost pool for completed contracts is $140,000, and $60,000 for contracts in progress. The variance remaining in the cost pool is $20,000. If Bulkhead Construction Company's allocation method is the ratio of the total credits to the cost pool for completed contracts to the total credits for contracts in progress for the year, how much of the $20,000 variance remaining in the cost poll should be allocated to completed contracts, and how much should be allocated to contracts in progress?

    a. $4,000; $16,000.

    b. $8,000; $12,000.

    c. $12,000; $8,000.

    d. $14,000; $6,000.

11. The Completed-contract (CC) Method is preferable when which of the following conditions exist?

    a. Reasonably dependable estimates cannot be made.

    b. Reasonably dependable estimates can be made.

    c. It is anticipated that the buyer will satisfy its obligation under the contract.

    d. It is expected that the contractor will perform its contractual obligations.

12. Which revenue recognition method should be used if the yearend is typically at the down point of the business cycle and jobs in process are small?

    a. The PC method.

    b. The CC method.

    c. Either the PC or CC method.

    d. Do not select this answer choice.

13. Guidelines for estimating costs to complete a project are provided in FASB ASC 605-35-25-44 (formerly SOP 81-1, Paragraph 78). Which of those guidelines listed below is **inaccurate**?

    a. The quantities and prices of all significant cost elements should be identified when estimating total contract costs.

    b. Estimating procedures should guarantee that the estimated cost to complete includes the same elements of cost that are included in actual accumulated costs.

    c. The basis for cost estimates on contracts of any length should be wages and prices in effect at contract inception (not future escalations).

    d. The accounting records should be used as a basis for periodically comparing actual and estimated costs.

14. Under the percentage-of-completion method, a change order should be charged to current operations in which of the following circumstances?

    a. If it is highly likely that the costs of the change order will be recovered by changing the contract price.

    b. If it is highly likely that change order costs will not be recovered.

    c. If it is highly likely that the change order will generate additional gross profit.

    d. Do not select this answer choice.

15. Claims made by the contractor against the owner may include all of the following **except**:

    a. Owner-caused delays.

    b. Errors in specifications.

    c. Contract terminations.

    d. Approved change orders.

16. Claims made by the contractor against the owner may be included in contract revenues to the extent contract costs relating to the claims have been incurred if a number of conditions exist. In cases where only some of the required conditions are met, recording those gains before realization is prohibited by FASB ASC 450-30-25-1 (formerly SFAS No. 5, Paragraph 17), and the claim is classified as which of the following?

    a. Provisional gain.

    b. Partial gain.

    c. Contingent gain.

    d. Qualified gain.

17. *Input methods* of determining the percentage of contract completion base the percentage of completion on which of the following?

    a. Efforts devoted to a contract.

    b. Results achieved.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

18. Big Top Construction Company has determined the percentage of completion of the contract it is currently working on. Now it needs to calculate the amount of revenues, costs, and profits to recognize using the percentage of completion. In accordance with SOP 81-1 (FASB ASC 605-35-25-82 through 84),if Big Top Construction Company decides to use *Alternative B* to recognize revenues, costs, and profits, which of the following accurately describes that method?

    a. Applies the percentage of completion to total estimated contract costs and total estimated contract revenue with the gross profit recognized being the difference between the two.

    b. Applies the percentage of completion to total estimated gross profit with the profit being added to costs incurred to calculate revenues recognized.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

Lesson 2: Financial Statement Considerations, Investments in Ventures, and Accounting for Similar Operations

INTRODUCTION

FINANCIAL STATEMENT CONSIDERATIONS

Construction contractors are generally subject to the same reporting and disclosure requirements as other commercial entities. Chapter 6 of the AICPA Audit and Accounting Guide, *Construction Contractors*, includes information unique to construction contractors in the area of financial statement presentation. This lesson addresses various financial statement considerations, with emphasis on areas that most commonly occur and/or are unique in the financial statements of construction contractors.

Learning Objectives

Completion of this lesson will enable you to:
- Summarize financial statement considerations and their effect on accounting for construction contracts.
- Describe investments in ventures and accounting for similar types of businesses.

Deciding Whether to Present a Classified Balance Sheet

A classified balance sheet distinguishes current assets and current liabilities from other assets and liabilities. The general criteria for separating current and noncurrent items are specified by FASB ASC 210-10 (formerly ARB No. 43, Chapter 3A), and are summarized as follows:

a. *Operating Cycle.* The time needed to convert cash first into materials and services, then into products, then by sale into receivables, and finally by collection back into cash.

b. *Current Assets.* Cash and other assets that are reasonably expected to be realized in cash or sold or consumed during one year, or within the company's normal operating cycle if it is longer than a year.

c. *Current Liabilities.* Obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities.

Although construction contractors often have contracts of varying durations, the normal operating cycle is measured by the average time between the inception of a contract and its substantial completion. Estimated time remaining to complete contracts *should not be used* to determine classification. For example, if a contractor usually builds under contracts lasting 18 to 24 months and most of the contracts have 6 to 9 months remaining to completion at year end, the normal operating cycle is 18 to 24 months.

Operating Cycle of One Year or Less. The contracts of most small contractors can generally be completed in one year or less. Although an unclassified balance sheet may be presented, a classified balance sheet is preferable and is normally presented in practice. If some assets and liabilities are classified as noncurrent because the related contracts have terms of greater than one year, information about their realization and maturity should be disclosed.

Operating Cycle Longer Than One Year. In most other industries, an unclassified balance sheet is preferable when the operating cycle exceeds one year. Although this is an acceptable option that may be used by construction contractors, the predominant practice is to classify all contract-related assets and liabilities as current based on the operating cycle concept and to classify other assets and liabilities based on the general guidance found in FASB ASC 210-10 (formerly ARB No. 43) (amounts expected to be realized or liquidated during the year would be classified as current).

The following assets and liabilities are generally considered to be contract-related for purposes of applying the guidance in the preceding paragraph.

Contract-related assets include:

a. Accounts receivable on contracts, including retentions (unless retentions will not be realized within the company's normal operating cycle, in which case they should be classified as noncurrent).

b. Unbilled contract receivables.

c. Costs and estimated earnings in excess of billings.

d. Other deferred contract costs.

e. Equipment and small tools specifically purchased for, or expected to be used solely on, an individual contract.

Contract-related liabilities include:

a. Accounts payable on contracts, including retentions (unless retentions will not be paid within the company's normal operating cycle, in which case they should be classified as noncurrent).

b. Accrued contract costs.

c. Billings in excess of costs and estimated earnings (unless billings exceed total estimated costs at completion of the contract plus contract profits earned to date, in which case such an excess should be classified as deferred income).

d. Deferred taxes caused by temporary differences in contract revenue and expense recognition methods.

e. Advanced payments on contracts for mobilization or other purposes.

f. Obligations for equipment specifically purchased for, or expected to be used solely on, an individual contract regardless of the payment terms of the obligations.

g. Provision for losses on contracts.

If a contractor has an investment in a construction joint venture that is presented on the cost or equity basis, the investment should be classified as noncurrent unless the venture is expected to be completed and liquidated during the current operating cycle of the contractor.

Offsetting or Netting Amounts

A basic reporting principle is that assets and liabilities should not be offset or netted against each other unless a *legal* right of setoff exists. In determining the report line items that will be recorded on the construction contractor's balance sheet, the following procedures are performed:

a. For each contract in progress at year end, the total cost incurred to date (including estimated earnings if the PC method is used) is reduced by the total amount of bills rendered to arrive at a net balance. The net balance will be a debit if total costs exceed total billings (underbillings) and a credit if total billings exceed total costs (overbillings).

b. All debit balances (costs exceed billings) are added together with the total shown as an asset on the balance sheet.

c. All credit balances (billings exceed costs) are added together with the total shown as a liability on the balance sheet.

d. Footnote disclosure should include the following components of uncompleted contracts:

(1) total costs incurred,

(2) total estimated earnings recognized (on the percentage-of-completion method), and

(3) total billings.

Unique Disclosures for Construction Contractors

Besides the financial statement disclosures generally required to be included in a commercial entity's financial statements, several other disclosures must be included by construction contractors. Chapter 6 of the AICPA Audit and Accounting Guide, *Construction Contractors*, discusses most of the additional disclosures that are required.

Supplementary Information That Is Sometimes Required

Bankers and bonding companies often require construction contractors to provide audited financial statements within a short time after year end. They may also require additional information in the form of supplemental schedules accompanying the basic financial statements.

Derivative Instruments

FASB ASC 815, *Derivative and Hedging* (formerly SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*), establishes accounting and reporting standards for derivative instruments and hedging activities. A summary of the standard's guidance is provided in the following paragraphs.

A derivative instrument is a financial instrument or other contract that has all three of the following characteristics:

a. It has at least one underlying (such as an interest rate, security price, commodity price, foreign exchange rate, price or rate index, or other variable, including the occurrence or nonoccurrence of a specified event) and at least one notional amount (such as a specified number of currency units, shares, bushels, pounds or other units) or payment provision (such as a fixed or determinable settlement to be made if the underlying performs in a specified manner) or both.

b. It requires no initial net investment or an initial net investment less than required for other types of contracts expected to respond similarly to changes in market factors.

c. The terms require or permit net settlement; it can be readily settled net outside the contract; or it provides for delivery of an asset that puts the recipient in a position similar to net settlement.

Derivative instruments do not, however, include items such as normal purchases and normal sales, "regular-way" security trades (trades providing for delivery of a security within customary timeframes established by marketplace regulations), certain investments in life insurance, certain loan commitments, certain insurance and investment contracts, certain financial guarantee contracts, certain contracts that are not traded on an exchange, or derivatives that serve as impediments to sales accounting. In addition, derivative instruments do not include contracts that are issued as contingent consideration in a business combination.

All derivative instruments subject to the provisions of SFAS No. 133 (FASB ASC 815), should be measured at fair value and recognized in the balance sheet as either assets or liabilities, depending on the rights or obligations under the contracts. Changes in the fair value of all derivative instruments should generally be recognized in earnings in the period of change.

Embedded Derivatives. Certain contracts that do not, in their entirety, meet the criteria above may have embedded derivative instruments; that is, instruments that have implicit or explicit terms that affect some or all of the cash flows or value of other exchanges required by the contract, similar to derivative instruments. Contracts that have embedded derivative instruments may include items such as bonds, insurance policies, or leases. An embedded derivative instrument should be separated from the host contract only if all of the following conditions are met:

a. The economic characteristics and risks of the embedded instrument are not closely related to those of the host contract.

b. The hybrid contract (the one that contains both the embedded and host instrument) is not remeasured at fair value with changes recognized as a change in financial position when they occur.

c. A separate instrument with the same terms as the embedded derivative instrument would meet the derivative instrument definition in paragraph . However, this condition is not met if the standalone contract would be classified as a liability (or an asset in certain situations) under the provisions of FASB ASC 480 (formerly SFAS No. 150) but would be reported in stockholder's equity without those provisions.

Disclosures. FASB ASC 815 (formerly SFAS No. 133) also establishes disclosure requirements related to derivative instruments and hedging activities.

Is a Construction Contract a Financial Instrument? The definition of a financial instrument in the glossary of SFAS No. 133 requires that there be an exchange of financial instruments. Since only the contractor receives cash, and the owner receives a combination of goods and services (goods and services are not financial instruments), construction contracts are not financial instruments.

Weather Derivatives. Weather derivatives are financial instruments available to contractors and other businesses to manage risk related to weather or geological variables. FASB ASC 815-45, *Weather Derivatives* (formerly EITF Issue No. 99-2), provides guidance on determining the accounting for weather derivatives. However, the guidance does not apply to contracts written by insurance companies that compensate the contractor for a liability or a change in the value of a specific asset that is the result of an insurable event.

FASB ASC 815-45-30 (formerly EITF No. 99-2) provides the following methods to account for weather derivatives depending on the purpose of the contract:

a. *Contracts Entered into for Speculative or Trading Purposes.* These contracts should be recorded at fair value with subsequent fair value changes reported in earnings.

b. *Contracts Entered into for Nontrading Purposes.* These contracts should be accounted for using the intrinsic value method of accounting. The intrinsic value method is the difference between actual period results and expected results of an upfront allocation of the cumulative strike based on reasonable expectations, multiplied by the contract price. The initial allocation of the cumulative strike amount should not be adjusted over the term of the contract to reflect actual results and contractors should quantify and remove any embedded premium or discount from the calculated benchmark strike. The premium should be amortized systematically to expense.

Because weather derivatives are financial instruments, they are subject to the disclosure requirements discussed above.

Fair Value Accounting Considerations

FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*), applies whenever other standards require (or permit) assets or liabilities to be measured at fair value, but it does not expand the use of fair value in any new circumstances. It provides a common definition of fair value, establishes a framework to measure fair value within GAAP, and modifies disclosures about fair value measurements.

FASB ASC 310-10-20 (formerly SFAS No. 157) defines *fair value* as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. That is, fair value is based on an exit price, which may differ from the price paid to acquire the asset or received to assume the liability (i.e., an entry price). If there is a principle market for the asset or liability, fair value represents the price in that market and transaction costs are not considered.

According to the fair value framework, quoted prices in active markets provide the most reliable evidence of fair value. If those prices are not available, fair value should be based on other observable inputs, such as quoted prices for similar assets in active markets, prices for identical or similar assets in markets that are less active, or prices based on market corroborated inputs. In the absence of observable inputs, fair value may be based on unobservable inputs, such as the reporting entity's own expectations about the assumptions market participants would use in pricing the asset in a current transaction, including assumptions about risk.

Certain disclosures are required about fair value measurements that indicate to financial statement users how the fair value estimates were produced, including information on whether the measurements are made on a recurring or nonrecurring basis. Those disclosures are generally designed to provide information about the subjectivity of the fair value measurements and are required in addition to any other disclosures required about fair value measurements.

Recent Developments to Provide Further Guidance on Fair Value Measurements. The FASB has recently issued the following ASUs to amend the fair value guidance:

- ASU No. 2009-05, *Fair Value Measurements and Disclosures: Measuring Liabilities at Fair Value*, was issued in August 2009 and amended several sections of FASB ASC 820-10. The guidance was issued to provide further details on measuring the fair value of liabilities when a quoted price in an active market for an identical liability is not available. Additional disclosure requirements were included as part of the ASU, which was effective for reporting periods beginning after August 2009.

- ASU No. 2009-12, *Fair Value Measurements and Disclosures: Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, was issued in September 2009 as a part of the FASB credit crisis projects and amended various sections of FASB ASC 820-10. It applies to certain types of investments primarily in hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds. Additional disclosure requirements were added for this type of investment. The guidance was effective for periods ending after December 15, 2009.

- ASU No. 2010-06, *Fair Value Measurements and Disclosures: Improving Disclosures about Fair Value Measurements*, was issued in January 2010 to amend the disclosure requirements in Topic 820-10. The guidance requires two new disclosures: (1) separate disclosures of significant transfers in and out of Levels 1 and 2 and the reasons for the transfers, and (2) separate disclosure of the activity in Level 3 fair value measurements (for example, purchases, sales, issuances, and settlements)which were often netted before. This ASU also clarifies that the fair value measurement disclosures should be for each class of asset and liability, and determining the appropriate classes requires judgment. The guidance is effective for fiscal years beginning after December 15, 2009, except for the roll-forward of activity in Level 3 measurements, which is effective for years beginning after December 15, 2010.

Pending Developments to Provide Further Guidance on Fair Value Measurements. At the time this course was completed, the FASB and IASB were working on a joint project to create converged fair value measurement guidance. To converge the guidance, the Boards have agreed that *fair value* should have the same meaning in U.S. GAAP and IFRS and fair value measurements should also be the same, except for minor differences in wording or style. An exposure draft of a converged standard is scheduled for the second quarter of 2010, while the final ASU is scheduled for the fourth quarter of 2010.

Common Fair Value Areas for Contractors. Generally accepted accounting principles include a number of requirements for fair value measurements, as well as requirements for measurements that, while they do not use the term fair value, are similar to fair value measurements. Construction contractors commonly see fair value measurement requirements in the following areas:

- Debt and equity securities
- Derivatives
- Long-term receivables (retentions)
- Long-lived assets
- Long-term debt

A comprehensive discussion of fair value considerations is beyond the scope of this course. Accordingly, the following paragraphs provide general information about fair value requirements that are commonly encountered by contractors. However, as explained below, comprehensive information on these fair value topics is available in *PPC's Guide to Preparing Financial Statements*.

Debt and Equity Securities. FASB ASC 320-10 (formerly SFAS No. 115) requires the carrying amount of debt and equity securities whose fair value is readily determinable and that are either trading securities or available for sale to be adjusted to their fair value. The underlying presumption is that, because fair value is readily determinable, it is an objective measurement and could readily be realized. Small and midsize contractors generally hold securities (if they hold any) that are traded on public stock exchanges. Accordingly, determining the fair value of such securities is simple. The accounting for unrealized appreciation and depreciation in the fair value of the securities generally depends on their use, with the change in the fair value of trading securities recognized in earnings and the change in the fair value of securities available for sale recognized in other comprehensive income.

Derivatives. As mentioned earlier, derivative instruments should be measured at fair value and recognized in the balance sheet as either assets or liabilities, depending on the rights or obligations under the contracts. One form of derivative—the interest rate swap—is relatively common to small and midsize contractors. Typically in this situation, the bank that holds a variable-rate note of the contractor enters into an interest rate swap with the contractor that is designed to effectively convert the note from a variable-rate note to a fixed-rate note. Accounting for the change in the fair value of derivatives depends primarily on whether hedge accounting is elected. If hedge accounting is elected, generally the portion of the change in fair value that is effective as a hedge is recorded as other comprehensive income and the ineffective portion is reported as earnings. If hedge accounting is not elected, all of the change is reported in earnings.

Long-term Receivables. Contractors often have amounts withheld from payment on in-process contracts until the contract is completed successfully. Such withheld amounts are known as *retention receivables*. When retention receivables are not expected to be collected within nine to twelve months of the balance sheet date, the face value of the receivable may be different than its fair value because generally there is no stated interest rate associated with retention receivables. These retention receivables (or payables) may be subject to the disclosure requirements of FASB ASC 825-10-50 (formerly SFAS No. 107, *Disclosures About Fair Value of Financial Instruments*), unless the contractor meets the scope exception provided in that guidance (that is, assets less than $100 million and no derivatives). Contractors that do not meet the exception should consider whether retention receivables (or payables) are material and, if so, whether there is a significant difference between the face amount and fair value of the balances that should be disclosed.

Long-lived Assets. Especially in these troubling economic times, contractors with significant property and equipment should carefully consider the possible impairment of long-lived assets. When it is determined that the carrying value of a long-lived asset will not be fully recovered, the asset is considered impaired. To calculate an impairment loss, the fair value of the affected asset(s), as well as the expected cash flows, must be determined. For long-lived assets (including asset groups) that have uncertainties both in timing and amount, an expected present value technique will often be the appropriate technique with which to estimate fair value.

Long-term Debt. In the current economic environment, contractors may have fixed-rate long-term debt with a stated interest rate that is higher than the current market interest rate for a similar loan. In that situation, contractors should consider whether a fair value measurement for the long-term debt is required. Applying the definition of fair value to debt requires assuming that a party would assume the debt of the reporting entity. There is not likely to be a market for the assumption of the debt of most small and midsize nonpublic contractors; therefore, the determination of fair value will need to be based on the assumption of a hypothetical market. A participant in a hypothetical market would likely assume debt for a price equal to the expected cash payments discounted at a current interest rate. That would require the buyer to estimate the payments the *contractor* expects to make and to estimate the rate the creditor would charge based on the *contractor's* credit standing. Even though the determination of fair value assumes a hypothetical market, there is likely to be observable data in analogous markets to select a discount rate.

Financial Guarantees

Contractors may guarantee the debt or other obligations of an equipment company, subcontractor, real estate venture, or a joint venture that it does not control. Contractors participating in joint ventures may also indemnify the surety against loss and thus be the responsible party for performing all contract obligations including construction, payment, and warranty. This indemnification normally qualifies as a guarantee under FASB ASC 460-10 (formerly FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indi-*

rect Guarantees of Indebtedness of Others). The guidance clarifies that a guarantor is required to recognize a liability for the fair value of a guarantee at the inception of the guarantee, and provides disclosure requirements.

Recognition and Measurement Provisions. FASB ASC 460-10-25-1 (formerly Paragraph 7 of FIN 45) excludes several types of guarantees from the recognition and measurement provisions, including the following:

a. Guarantees issued between parent entities and their subsidiaries,

b. Guarantees between corporations under common control, and

c. A parent company's guarantee of its subsidiary's debt to a third party.

However, these guarantees are not excluded from the disclosure provisions discussed below.

When a guarantee is issued, the guarantor is obligated in two ways: (a) a contingent obligation to perform when a specified triggering event occurs, such as the original debt issuer failing to make the required payments of its debt facilities, and (b) a noncontingent obligation to be ready to perform during the term of the guarantee if one or more events occur. The contingent liability should be accounted for; that is, a liability should be recorded when it is probable that a loss has been incurred and the amount is reasonably estimable. The accounting for the noncontingent obligation is discussed in the following paragraph.

The fair value of the guarantee is determined differently depending on the circumstances of the guarantee. If the guarantee is issued in a standalone, arm's-length transaction with a third party, the fair value is generally the premium received or receivable by the guarantor. However, in an arm's-length transaction with a third party that includes several elements, such as an operating lease, the fair value may be measured by comparing to similar transactions where the value of the guarantee was determined.

Recording the debit side of the transaction depends on the circumstances causing the guarantee to be issued. FASB ASC 460-10-55-23 (formerly Paragraph 11 of FIN 45) presents several examples. In the authors' opinion, one of the more common situations could be when a guarantee is issued at the formation of a joint venture accounted for under the equity method by the guarantor. In that situation, the offsetting debit would be to increase the investment in the entity. Other situations may require the debit to be to an expense account, to a cash or receivable account, or to the gain or loss recorded on a transaction.

Disclosure Provisions. FASB ASC 460-10 (formerly FASBI No. 45) has strengthened the financial disclosure requirements for off balance sheet financial guarantees. Contractors must consider accrual of liabilities and/or disclosure of financial guarantees related to warranties, self-insurance deductibles, non-bonded subcontractors, bid prices, and similar items.

Environmental Cleanup Costs

Environmental cleanup costs can significantly impact contractors. There are numerous federal, state, and local environmental laws and related regulations. Construction companies can become involved in environmental claims in various situations including, but not limited to, the following:

- Fuel and chemical storage tanks leak hazardous substances into the soil and ground water at construction sites and on properties owned by the company.
- Excavating contractors grade land that is later discovered to contain hazardous substances.
- Excavating and demolition contractors or others transport materials containing hazardous substances.
- Contractors dump materials containing hazardous wastes into landfills.
- A project involves asbestos or other hazardous waste removal.
- Hazardous wastes, such as buried drums of toxic materials, are discovered on a job site.

- Chemicals or other materials used on a job site are considered hazardous.
- Real estate transactions or mergers involve property with environmental risks.

The contractor need not be aware that the material is hazardous to be held liable. Many unsuspecting contractors find themselves facing claims for the cleanup of hazardous material left over from or removed from a project site when they had no knowledge of the hazardous substance. Some of the ways that contractors can minimize their risks of being involved in environmental claims include:

- Inspect the site for environmental warning signs, such as discolored soil or exposed pipes, prior to bidding on a project.
- Look for signs of past industrial activities on the property and consider reviewing public records for registered storage tanks.
- Review the property's environmental history included in EPA and federal and state agency records.
- Obtain a copy of the owner's environmental survey or audit of the property, if one was conducted.
- Include a contract clause that makes the owner responsible for all such claims. (This clause is only as good as the owner providing it. If the owner becomes insolvent or fails to honor the agreement, the government or other third parties can still pursue the contractor as a responsible party.)
- Purchase environmental liability insurance. However, the insurance might be cost prohibitive and difficult to acquire.

Federal Environmental Laws. These are the federal environmental laws that most environmental cleanup obligations are based on—

a. *Superfund Laws.* The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) and the Superfund Amendments and Reauthorization Act established the Superfund, which is used primarily to clean up facilities that are abandoned or inactive or whose owners are insolvent. The Environmental Protection Agency (EPA) has the authority to order responsible parties to remediate contaminated sites, or to use Superfund money to remediate the sites and then seek reimbursement for cleanup costs from potentially responsible parties (PRPs). There are four classes of PRPs—

   (1) Current owners or operators of sites at which hazardous substances have been disposed of or abandoned.

   (2) Previous owners or operators of sites at the time of disposal of hazardous substances.

   (3) Parties that arranged for disposal of hazardous substances found at the sites.

   (4) Parties that transported hazardous substances to a site, having selected the site for treatment or disposal.

b. *Resource Conservation and Recovery Act of 1976 (RCRA).* RCRA provides for comprehensive regulation of hazardous wastes from origination to final disposal. It imposes cleanup obligations on any party that has "contributed to" the disposal of waste that is causing an imminent and substantial endangerment.

Authoritative Literature. The following literature provides the primary guidance on accounting for environmental cleanup costs and liabilities:

- FASB ASC 450-20 (formerlySFAS No. 5, *Accounting for Contingencies*), provides general guidance on accruing liabilities for loss contingencies.
- FASB ASC 410-20 (formerly SFAS No. 143, *Accounting for Asset Retirement Obligations*), provides accounting and reporting guidance that applies to environmental remediation obligations arising from the normal operation of a long-lived asset and that is associated with the retirement of that long-lived asset.

- FASB ASC 410-30 (formerly SOP 96-1, *Environmental Remediation Liabilities*), provides specific guidance for recognizing, measuring, and disclosing environmental remediation liabilities.
- FASB ASC 410-30-25-16 through 25-19 (formerly EITF Issue No. 90-8, *Capitalization of Costs to Treat Environmental Contamination*), provides guidance for determining whether environmental cleanup costs should be capitalized.
- FASB ASC 360-10-55 (formerly EITF Issue No. 95-23, *The Treatment of Certain Site Restoration/Environmental Exit Costs When Testing a Long-Lived Asset for Impairment*), addresses whether future cash flows for environmental exit costs associated with a long-lived asset should be included in the undiscounted expected future cash flows used to test property for recoverability.

Capitalization of Environmental Cleanup Costs. FASB ASC 410-30-25-18 (formerly EITF Issue No. 90-8) provides the primary guidance on capitalization of environmental cleanup costs. According to that guidance environmental cleanup costs should be capitalized only if—

a. The costs are recoverable, and

b. At least one of the following conditions is met:

   (1) The costs are incurred in preparing for sale property that is currently held for sale.

   (2) The costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company. Also, the costs must improve the condition of the property compared to its condition when originally built (or bought, if later).

   (3) The costs lessen or prevent environmental contamination that has not yet occurred but might otherwise result from future operations or activities. Also, the costs must improve the condition of the property compared to its condition when originally built (or bought, if later).

Special Considerations for Construction Contractors. The authoritative literature on accounting for environmental cleanup costs and liabilities focuses primarily on the owners of the contaminated property. Construction contractors can incur environmental cleanup costs in three primary ways, and best practices indicate that the accounting can vary depending on the circumstances. The following guidance is offered:

a. *Cleanup Contract.* A contractor may enter into a contract to clean up existing contamination at a project site. In that case, the cleanup costs would generally be accounted for like costs under any other long-term contract.

b. *Property Owner.* The contractor might acquire property for its own use or speculative building, and that property might be contaminated for a variety of reasons. In that case, the environmental cleanup costs and liabilities should be accounted for as discussed above.

c. *Project Contamination.* A contractor might become associated with a contaminated project site, for example, because of the actions of employees or subcontractors. In that case, environmental liabilities should be accrued in accordance with FASB ASC 450-20 (formerly SFAS No. 5) and FASB ASC 410-30 (formerly SOP 96-1). However, best practices indicate that the related costs should generally be charged to expense.

Accruing Environmental Remediation Liabilities

Environmental remediation liabilities can be challenging to account for. First, it is difficult to determine when a liability has been incurred because it often cannot be easily associated with a single event. Second, the amount of the liability is often difficult to reasonably estimate until long after the problem has been identified. Engineers might be able to estimate some costs, but significant uncertainties surround the full cleanup cost. FASB ASC 410-30 (formerly SOP 96-1) provides more specific guidance for recognizing, measuring, and disclosing liabilities for legally required environmental remediation. In summary, environmental remediation liabilities should:

- Be accrued on a site-by-site basis when the criteria of FASB ASC 450-20-25-2 (formerly SFAS No. 5) are met, using defined benchmarks for determining when those criteria are met.

- Include incremental direct costs, as well as compensation and benefit costs for employees who devote significant time to remediation activities.
- Include costs for the company's specific share of the liability for the site, as well as the company's share of costs that will not be paid by the government or other PRPs.
- Be estimated based on enacted laws and regulations.
- Be estimated based on expected improvements in remediation technology and productivity.
- Consider discounting when appropriate.

In addition, environmental remediation obligations are not unusual in nature and do not meet the criteria for classification as extraordinary items.

Determining When to Accrue a Liability. It is probable that an environmental remediation liability has been incurred when the following two elements are met on or before the date the financial statements are issued or are available to be issued:

a. It has been asserted or it is probable that it will be asserted (through litigation, claim, or regulatory assessment) that the contractor is responsible for participating in an environmental remediation process as a result of a past event (which occurred on or before the date of the financial statements).

b. It is probable that the result of the litigation, claim, or assessment will be unfavorable and the contractor will be held responsible.

If an assertion has been made or is probable of being made and if the contractor is associated with the site (as an owner, previous owner, operator, or was responsible for disposing of or transporting the hazardous substances at the site), there is a presumption that the outcome of the litigation, claim, or assessment will be unfavorable.

The fact that particular components of the overall environmental remediation liability may not be reasonably estimated during the early stages of the remediation process should not preclude recognizing a liability. In addition, uncertainties regarding the contractor's share of an environmental remediation liability should not preclude the contractor from recognizing its best estimate of its share of the liability. Therefore, the following benchmarks are provided for determining when an environmental remediation liability meets the accrual criteria:

- *Identification and Verification of the Contractor as a PRP.* If the contractor determines that it is associated with a Superfund or RCRA site, it is probable that a liability has been incurred, and the liability should be accrued when all or a portion of it is reasonably estimable.
- *Receipt of Order or Mandates to Take Interim Corrective Measures.* For example, a company might receive a unilateral administrative order from the EPA requiring it to take a "response action" or risk substantial penalties. In these situations, the cost of performing the required work generally is estimable within a range, and the company should not delay accruing a liability for costs of removal actions beyond this point.
- *Participation as a PRP in a Remedial Investigation or Feasibility Study.* At this stage, the company generally has agreed to pay the costs of a study to investigate the environmental impact of the contamination and identify remediation alternatives for the site. The cost of the investigation generally can be estimated within a reasonable range. As the investigation proceeds, the company's estimate of its share of the total cost of the investigation can be refined.
- *Completion of Feasibility or Corrective Measures Study.* When the feasibility or corrective measures study is substantially complete, the company generally will be able to reasonably estimate both a minimum remediation liability and the company's allocated share of the liability.
- *Issuance of Record of Decision (ROD) or Approval of Corrective Measures Study.* At this stage, the EPA has issued its decision specifying a preferred remedy, and the company can refine its estimated liability based on the specified remedy and a preliminary allocation of total remediation costs.

- *Remedial Design and Implementation of Corrective Measures.* During the design phase of the remediation, engineers develop a better estimate of the work to be performed and can provide more precise estimates of the total remediation costs. The company should continue to refine and recognize its best estimate of its share of the liability as additional information becomes available throughout the operation and maintenance of the remedial action plan.

The preceding benchmarks should be considered when evaluating the probability that a loss has been incurred and the extent to which the loss is reasonably estimable. However, these benchmarks should not be applied in a way that would delay recognizing an environmental remediation liability beyond the point at which a liability would be recognized.

If the contractor cannot estimate a single loss amount, the guidance in FASB ASC 450-20-30-1 (formerly FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*) is cited, which allows companies to define a *range* of estimated losses and record the amount in the range that is the best estimate. (If no amount in the range is a better estimate than any other amount, the Interpretation requires using the lowest amount in the range.) Thus, in practice, the contractor generally should define the range of an estimated environmental remediation liability and refine the estimate as activities in the remediation process occur. Subsequent changes in estimates of the contractor's liability should be accounted for as changes in estimates. Consideration should also be given to the need for additional disclosures related to risks and uncertainties.

Estimating Environmental Remediation Costs. Environmental remediation liabilities should provide for the following costs:

a. Incremental direct costs, including—

   (1) Legal fees paid to outside law firms for work related to determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.

   (2) Costs related to the remedial investigation or feasibility study.

   (3) Engineering and consulting fees paid to outside firms for site investigations and development of remedial action plans and designs.

   (4) Other companies' costs for performing remedial actions (such as soil removal and disposal).

   (5) Government oversight costs, such as fines.

   (6) Costs of equipment that is dedicated to remedial actions and does not have an alternative use.

   (7) PRP group assessments to cover costs incurred by the group in dealing with a contaminated site.

   (8) Costs for operation and maintenance of the remedial action, including postremediation monitoring.

b. Compensation and benefits costs for employees who devote significant time directly to remediation activities, including—

   (1) Internal legal staff involved with determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.

   (2) Technical employees involved with remediation activities.

   Costs of compensation and benefits should be allocated based on time spent on these activities.

Costs related to routine environmental compliance matters and legal costs associated with potential recoveries should not be included in remediation costs. However, GAAP does not provide guidance on whether the costs of defending against liability claims and assertions should be included in the measurement of the environmental remediation liability. Best practices indicate that such costs should be included in the measurement of the liability to the extent they are probable and reasonably estimable.

Allocating Shared Costs among Responsible Parties. To record an environmental remediation liability, the company must determine its share of the total remediation liability. This is a subjective estimate based on many factors, including the following:

- *Who Are the PRPs for the Site?* Generally, the EPA will notify the company that it is a PRP, along with other PRPs identified by the EPA. However, depending on the available information, the EPA may not be aware of all PRPs. In that case, the company, along with other identified PRPs, should consider investigating to find other parties who may be liable for a portion of the remediation costs.

- *What Is the Percentage of the Total Liability That Will Be Allocated to the Company?* Several factors can be considered in allocating liability among PRPs, such as volumetric measures, the type of waste, whether the PRP was a site operator or owner, the degree of care exercised by the PRP, and any statutory or regulatory limitations on contributions from some PRPs. As a practical matter, the allocation often is determined by agreement among the parties, by hiring an allocation consultant, or by requesting that the EPA determine an allocation. The percentage for the entire remediation effort, not just a portion, should be used to determine the company's allocable share of the total remediation liability.

- *What Is the Likelihood the Other PRPs Will Pay Their Full Share of the Liability?* The company should assess the likelihood that the other PRPs will pay their allocable portion of the total remediation liability. That assessment generally is based on the financial condition of the other PRPs and must be monitored as the remediation progresses. Any amounts that will not be paid by other PRPs must be allocated among the remaining PRPs and included in the remaining PRPs' liabilities.

As mentioned previously, uncertainties in determining the company's share of the remediation liability should not preclude the company from recognizing its best estimate of its share of the liability, or at least the minimum estimate of its share of the liability if a best estimate cannot be made.

Effect of Changes in Laws and Regulations. The accrual of environmental remediation liabilities should be based on enacted laws and adopted regulations, not on anticipated changes in those laws and regulations. The company should recognize the impact of changes in laws and regulations when those changes are enacted or adopted.

Technology and Productivity Improvements. The accrual also should be based on remediation technology and methods expected to be approved to clean up the site. Therefore, when measuring its liability, the company should consider anticipated advances in technology only to the extent that the company has a reasonable basis to expect that a remediation technology will be approved. The uncertainty regarding the technology is removed when the regulatory agency issues its ROD or approved remediation order. At that point, the remediation technology to be used is considered to be defined.

The accrual of the environmental remediation liability also should be based on the estimated costs to perform each phase of the remediation effort at the time the phase is expected to be performed, considering such factors as inflation and productivity improvements due to experience with similar sites and similar remedial action plans.

Use of Discounting. An environmental remediation liability, or a component of the liability, may be discounted to reflect the time value of money only if *both* of the following are fixed or reliably determinable:

a. The company's share of the aggregate liability amount, or component thereof.

b. The amount and timing of cash payments for the liability or component.

If the company can estimate only a range of possible loss from an environmental liability or other uncertainties exist about the timing of expenditures, discounting is not appropriate.

Claims for Recovery. Contractors may be able to pursue recoveries of amounts expended for environmental remediation from a variety of sources, including insurers, nonparticipating PRPs, the government, or other third parties. GAAP requires the amount of an environmental remediation liability to be determined independently from any potential claim for recovery. Furthermore, an asset related to a potential claim for recovery should be recognized only when realization of the claim is considered probable. (If a claim for recovery is being litigated, realization

of the claim generally is not considered probable.) A potential claim for recovery should be measured at its fair value, considering both the costs related to the recovery and the time value of money. However, the time value of money should not be considered if the related liability is not discounted and timing of the recovery depends on the timing of paying the liability. In addition, the guidance from FASB ASC 210-20-45 (formerly FIN 39, "Offsetting of Amounts Related to Certain Contracts"), is cited, which states that liabilities should not be presented net of related receivables unless there is a legal right of offset. The guidance concludes that environmental remediation liabilities and related claims for recovery rarely, if ever, meet the requirements for offsetting. Thus, presentation of the gross liability and related claim for recovery in the balance sheet generally is appropriate.

Effect on Property Impairment. In addition to recognizing a liability for the costs of curing violations of environmental regulations, contractors should consider whether environmental regulations impose restrictions on the future use of the property, if they own the property in question. Significant restrictions on the property's future use could reduce the property's fair value or its ability to generate future cash flows. In that case, the property's carrying amount may not be recoverable and the contractor may need to recognize an impairment loss.

Impairment of Long-lived Assets

Sometimes changes in operating conditions raise doubts about a contractor's ability to fully recover the carrying value of a particular asset. When it is determined that the carrying value will not be fully recovered, an asset is considered impaired. FASB ASC 360-10 (formerly SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets*) provides guidance on the recognition and measurement of an impairment loss. FASB ASC 360-10-35-21 (formerly Paragraph 8 of SFAS No. 144) provides examples of changes in circumstances that may indicate that the carrying amount may not be recoverable.

FASB ASC 360-10-15-4 and 15-5 (formerly SFAS No. 144) applies to recognized long-lived assets, including capital leases of lessees, long-lived assets of lessors subject to operating leases, and long-term prepaid assets. It does not apply to goodwill; intangible assets not being amortized; financial instruments, including investments in equity securities accounted for under the cost or equity method; deferred policy acquisition costs; or deferred tax assets.

If a long-lived asset is part of a group of assets that may include other assets and liabilities not covered by FASB ASC 360-10 (formerly SFAS No. 144), then that guidance applies to the group. An asset group is the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. The guidance in the following paragraphs applies to either an individual asset or to the asset group. Therefore, the term *long-lived asset* can generally be considered synonymous with *asset group*.

Classification of a Long-lived Asset. GAAP provides different accounting requirements depending on whether a long-lived asset is to be held and used, disposed of by sale, or disposed of other than by sale. However, the need to classify long-lived assets into these three categories depends on the facts and circumstances as follows:

- Disclosure of long-lived assets held for sale is required, regardless of whether they are impaired. Therefore, management should always identify the long-lived assets that the business intends to dispose of through a sale and value the assets accordingly.

- For long-lived assets that are not being held for sale, classifying them as to be disposed of other than by sale or held and used is not necessary unless there is an indication that the assets may be impaired.

Is an Impairment Assessment Necessary? Authoritative literature does not require a contractor to routinely perform cash flow analyses on all of its long-lived assets to determine if they are fully realizable from future activities. A long-lived asset to be held and used should be tested for recoverability if events or changes in circumstances indicate that its carrying amount may not be fully recoverable. The following are examples of events or changes in circumstances that might indicate that an asset's carrying amount is not recoverable:

- A significant decline in the asset's market value.

- A significant adverse change in the extent or manner of the asset's use (for example, a significant decline in the use of a machine).

- A significant adverse physical change in an asset (for example, physical damage).
- Adverse changes in legal factors or the business climate that could affect the value of the asset (for example, a machine suddenly becomes obsolete, or changes in environmental regulations significantly restrict the use of a particular machine).
- Significant cost overruns beyond the amount originally expected to be needed to acquire or build the asset.
- A current period operating or cash flow loss combined with a history of operating or cash flow losses associated with a long-lived asset.
- A current expectation that it is more likely than not (greater than 50% likelihood) that an asset will be sold or disposed of before the end of its previously estimated useful life.

The preceding list is not all-inclusive. Other factors might raise doubts about the recoverability of an asset, and, if they do, the contractor should assess the asset for impairment.

In the current industry downtown resulting from the economic crisis, some contractors may find that more of their equipment is idle and for longer periods of time. Additionally, the market for used equipment is oversaturated in many geographic areas. As a result, two of the events mentioned in the previous paragraph (a significant decline in the asset's market value and a significant adverse change in the extent of the asset's use) may have occurred indicating that the assets' carrying amounts may not be recoverable. In this situation, company management and the practitioner should consider whether the value of such equipment has been impaired. If it is determined that impairment has occurred, the loss should be recognized and disclosure is required. Calculating an impairment loss is discussed in the following paragraphs.

Assets to Be Held and Used or Held for Disposal Other Than by Sale. An entity must be able to estimate both the expected cash flows and the fair value of a long-lived asset to calculate an impairment loss. Essentially, if the estimated undiscounted cash flows from a long-lived asset (whether held and used or held for disposal other than by sale) are at least equal to the asset's carrying amount, no adjustment is required and no impairment loss is recognized. However, if the carrying amount exceeds the estimated undiscounted cash flows, the entity should recognize an impairment loss through a charge to earnings and a reduction of the asset's carrying amount for any excess. GAAP does not address whether the reduction should be accomplished through a credit to the asset account or to a valuation allowance. As a practical matter, the authors believe crediting a valuation allowance may be the best approach for most small and midsize entities. That will enable management to readily identify the temporary difference that arises because impairment losses are not deductible in computing taxable income until they are realized.

Upon recognizing an impairment loss, the adjusted carrying amount becomes the asset's new cost basis. It should not be adjusted for subsequent increases in fair value. However, it continues to be subject to the impairment requirements and future tests for recoverability should be based on comparisons with the new cost basis. Additionally, the new cost basis of a long-lived asset (whether classified as held and used or held for disposal other than by sale) should be depreciated over the estimated remaining useful life of the asset. As a practical matter, the events or changes in current circumstances that led to the impairment may have affected the remaining useful life. If the contractor plans to abandon the asset, the method used to depreciate it should result in a carrying amount at the date of abandonment equal to the expected salvage value, if any.

When an entity tests a group of assets for recoverability and an impairment loss is indicated for the group, the loss should be allocated to the individual long-lived assets in the group. The allocation should generally be in proportion to the carrying amounts of the individual long-lived assets. However, to the extent the fair value of individual long-lived assets can be determined without undue cost and effort, the allocation should not reduce the carrying amount of any long-lived asset below its fair value. The remaining useful life of the asset group should be based on the remaining useful life of the group′s primary asset. The primary asset is the principal tangible long-lived asset being depreciated or intangible asset being amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity.

The remaining useful life of the asset group should be based on the remaining useful life of the group's primary asset. The primary asset is the principal tangible long-lived asset being depreciated or intangible asset being

amortized that is the most significant component asset from which the asset group derives its cash-flow-generating capacity.

Assets Held for Sale. A number of criteria must be met before a long-lived asset can be classified as held for sale. All of the following conditions are required for classification as held for sale:

a. Management with the proper authority has committed to a plan to sell the asset.

b. The asset, in its present condition, is immediately available for sale (subject only to the usual and customary sales terms for similar assets).

c. The entity has initiated an active program to find a buyer and the asset is being actively marketed at a reasonable price considering its current fair value.

d. Sale of the asset is probable and expected to be completed within one year. FASB ASC 360-10-45-11 (formerly SFAS No. 144) permits an exception to this requirement when certain conditions beyond the entity's control exist.

e. It is unlikely that the plan of sale will significantly change or be abandoned prior to completion.

Long-lived assets that meet the held for sale criteria should be reported at the lower of the carrying amount of the long-lived asset or the fair value less selling costs. An impairment loss should be recognized for any initial or subsequent adjustment to the carrying amount of the long-lived asset to fair value less cost to sell. Once an asset has been classified as held for sale, it should no longer be depreciated.

S Corporations

S corporations are considered by many sureties to have a higher degree of risk than C corporations. Sureties have difficulty in assessing the timing and amount of stockholder withdrawals from S corporations. This difficulty is caused by the following:

- The removal of current and deferred income tax liabilities from the corporate financial statements does not mean the liability has gone away. While the taxes are paid at the personal level, it is likely that the funds will come from the corporation. However, the ability of the surety to assess the timing and amount of these withdrawals is greatly reduced. Sureties often make their own calculations of what such withdrawals will be; however, their projections of amounts to be paid are usually greater than the actual amounts.

- In addition to withdrawals for income tax payments, stockholders seem more inclined to make distributions (dividends) from S corporations than C corporations. This is because taxable income that was previously passed through and was subject to tax at the stockholder level is generally not subject to additional tax when dividends are distributed.

- Because of the difficulties in projecting and controlling withdrawals, sureties are forced to place more emphasis on the personal net worth of the owners than is usually necessary for C corporations. Sureties often require reviewed or compiled personal financial statements from owners of S corporations.

What Information Should Be Provided a Surety? The following additional disclosures, while not required by GAAP, should be considered for S corporations:

a. A description of tax method(s) used to recognize income from construction contracts.

b. Retained earnings and changes in retained earnings segregated into the following components.

(1) *Accumulated Adjustments Account.* The accumulated adjustments account essentially represents undistributed tax basis retained earnings as of the balance sheet date arising *after the date of conversion* to an S corporation. It excludes temporary differences that originate or reverse after the date of conversion and only includes permanent differences relating to nondeductible expenses incurred after the date of conversion.

(2) *Tax Temporary Adjustments Account.* The tax temporary adjustments account represents cumulative temporary differences as of the balance sheet date. The account is adjusted for temporary differences that originate and reverse after the conversion.

(3) *Accumulated Undistributed Non-taxable Income and Income Previously Taxed.* This amount represents undistributed tax basis earnings at the date of conversion plus other amounts that consist primarily of tax-exempt income since conversion.

c. A summary of the tax temporary adjustment account at the balance sheet date and changes for the current year.

d. The anticipated amount and timing of stockholder withdrawals after the financial statement date for payment of personal income tax liabilities.

Illustrated Disclosures. The disclosures discussed in the preceding paragraph are made in various ways. One method is to include all of the disclosures in supplementary information. (Inclusion in supplementary information is permissible since the disclosures are not required by GAAP.) Another method is to include Item b. in the statement of retained earnings and Items a., c., and d. in notes to financial statements. Some accountants include all of the disclosures in a note to the financial statements. Such a note (which also includes the GAAP requirement to disclose why no income tax expense is recorded) is presented in Exhibit 2-1.

Exhibit 2-1

Illustrated Income Tax Note to S Corporation Financial Statements

Income Taxes

Effective January 1, 19X1, the Company elected to be taxed as an S Corporation. Income for 20XX has accordingly been taxed to the stockholders as individuals and not to the corporation. The Company recognizes income on its construction contracts for income tax purposes using the percentage-of-completion method, which, as described in Note 1, is the same method used for financial statement purposes.

Retained earnings at December 31, 20XX, and changes for the year then ended, for income tax purposes are summarized as follows:

	Accumulated Adjustment Account	Tax Temporary Adjustments Account	Accumulated Undistributed Non-taxable Income and Income Previously Taxed	Total
Balance, beginning of year	$ 231,000	$ 21,000	$ 234,000	$ 486,000
Income taxed to stockholders	77,000	6,000	—	83,000
Nondeductible expenses	(2,000)	—	—	(2,000)
Non-taxable interest income	—	—	3,000	3,000
Dividends	(150,000)	—	—	(150,000)
Balance, end of year	$ 156,000	$ 27,000	$ 237,000	$ 420,000

The Tax Temporary Adjustments Account at December 31, 20XX, and changes for the year then ended, include the following:

	At December 31, 20XX	Year Ended December 31 20XX
Excess of tax over financial statement depreciation	$ 6,000	$ 1,500
Allowance for doubtful accounts	13,500	3,500
Accrued employee benefits	7,000	1,000
Other	500	—
	$ 27,000	$ 6,000

The Company plans to pay dividends totaling $20,000 to stockholders in March 20XY for payment of personal income taxes arising from the Company's 20XX income.

* * *

Discontinued Operations and Costs to Exit an Activity

Construction companies are often involved in more than one construction-related activity such as the following:

- A general contractor might provide certain subcontractor services. For example, a residential general contractor might also complete the plumbing or concrete work for the project. A highway general contractor might complete the road painting aspects of the job.
- One company might perform the functions typically performed by two subcontractors such as providing both the plumbing and electrical work for a particular project.
- One contractor might perform the general contractor function for both single-family and multi-family construction projects.
- One company might construct both highways and single-family houses.

If a construction company decides to stop one of its activities, it has to evaluate whether to report any related gain or loss as a discontinued segment or as a separate component of continuing operations. When the activity represents a separate major line of business or class of customer, any related gain or loss should be accounted for as a discontinued segment (after income from continuing operations) in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (FASB ASC 205-20). When the activities do not represent a component of a business, any related gain or loss should be reported as a separate component of income from continuing operations in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (FASB ASC 420-10).

Discontinued Operations. FASB ASC 205-20 (formerly SFAS No. 144) broadens the presentation of discontinued assets to include a component. A component may be a reportable segment or an operating segment, as defined by FASB ASC 280-10-50-1 (formerly SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*), a reporting unit, as defined under FASB ASC 350-20-35-33 through 35-38 (formerly SFAS No. 142, *Goodwill and Other Intangible Assets*), a subsidiary, or an asset group. Assets classified as held for sale should not be depreciated, and expected future losses associated with operations of long-lived assets to be sold should not be accrued before they occur; therefore, gains and losses on assets committed to a plan of disposal are no longer measured on a net realizable value basis.

Costs to Exit an Activity. GAAP for exit or disposal cost obligations at FASB ASC 420-10 (formerly SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*) applies to the following:

- Costs associated with disposal activities accounted for under FASB ASC 205-20 (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*).
- Costs associated with exit activities, such as restructurings, and exit activities not related to an entity recently acquired in a business combination.

- Costs related to the consolidation of facilities or the relocation of employees.
- Costs to terminate a contract, other than a capital lease.
- Costs associated with one-time employee termination benefits.

The timing of the recognition and measurement of exit or disposal costs differ depending on the type of costs associated with the activity. However, costs are accrued only when the definition of a liability is met.

Costs related to exit or disposal activities should be included in income from continuation operations unless the costs are associated with a discontinued operation. In that case, the costs should be included in the results of discontinued operations.

Risks and Uncertainties

In general terms, uncertainty stems from the inability to predict the future, and risks exist because uncertainty exists. FASB ASC 275 (formerly SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*) requires entities to—

- Disclose risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term or the near-term functioning of the company.
- Communicate to financial statements users the inherent limitations in financial statements.

GAAP does not require disclosure of all risks and uncertainties, which would be an overwhelming task, but requires disclosure of certain risks and uncertainties that meet specified criteria. Specifically, disclosures should be considered in the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.
- Certain significant estimates.
- Vulnerability resulting from concentrations.

The first two disclosures, nature of operations and use of estimates, are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria. *The accounting guidance does not prohibit additional disclosures about risks and uncertainties even if they are specifically excluded from the scope or do not meet the criteria that requires disclosure.*

An extensive discussion of FASB ASC 275 (formerly SOP 94-6) is outside the scope of this course. However, the next several paragraphs provide an overview of the four areas where disclosure should be considered and discuss how those disclosures might be applied to construction contractors. The requirements are summarized in Exhibit 2-2.

Exhibit 2-2

Disclosing Significant Risks and Uncertainties under SOP 94-6

	Nature of Operations	Use of Estimates	Certain Significant Estimates	Concentrations
When to Disclose?	Always.	Always.	• It is at least reasonably possible that the estimate of the effect on the financial statements of an existing condition will change in the near term due to future confirming events. AND • The change in estimate would have a material effect on the financial statements.	• A concentration exists at the financial statement date. AND • The concentration increases the company's vulnerability to the risk of a near term severe impact. AND • It is reasonably possible that the events able to cause the severe impact could occur in the near term.
Threshold for Disclosing?	N/A	N/A	Potential *material* effect on financial statements.	Potential *severe* impact to the company.
What to Disclose?	• Description of major products or services. • Relative importance of each business. • Basis used to determine relative importance of each business. • Principal markets and locations of the markets.	Explanation that management estimates are used in preparing financial statements.	• Nature of uncertainty. • An indication that it is at least reasonably possible that a change will occur in the near term.	• Description of the concentration. • Information about the general nature of the risk associated with the concentration. • Additional disclosures for concentrations of labor or foreign operations.

* * *

Nature of Operations. All financial statements should include a description of the major products or services the reporting entity sells or provides and the entity's principal markets, including the locations of those markets. Finally, if the entity operates in more than one business, disclosures must indicate the relative importance of each business and the basis for determining relative importance. Relative importance can be based on such things as assets, revenues, or net income, and does not have to be quantified. It can be communicated by using terms such as *predominantly, about equally*, or *major*. The following are examples of disclosures of a contractor's nature of operations:

> Do-It-Right Contractors, Inc. acts as the general contractor in constructing multi-family residential buildings in the Greater Chicago area. In addition, it provides property management services throughout the Midwest United States. The two business units are about equal in size based on gross profit contributions to the Company.

*****

Southwest R & B, Inc. constructs roads and bridges principally for the states of Texas and Arkansas.

Use of Estimates. GAAP requires financial statement disclosures to include an explanation that preparation of financial statements requires the use of management's estimates. The disclosure will usually be standardized (that is, boilerplate). The disclosure normally should be included in the summary of significant accounting policies.

Certain Significant Estimates. GAAP requires additional disclosures for certain *significant* estimates. According to FASB ASC 275-10-50-8 (formerly SOP 94-6), disclosure regarding an estimate is required "when known information available before the financial statements are issued or are available to be issued (as those terms are defined by GAAP for subsequent events), indicates that both of the following criteria are met:

- It is at least reasonably possible that the estimate *of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements* will change in the near term *due to one or more future confirming events*. [Emphasis added.]

- The effect of the change would be material to the financial statements."

When applying the criteria it is important to only consider conditions, situations, or circumstances that *already exist. It is not appropriate or necessary to speculate about new events*. That helps to narrow the range of possibilities when disclosure might be appropriate. For example, assume that Hometown Construction Company is concerned about the possibility of Big City Construction Co. entering its markets and the effect of such an entrance on its financial statement estimates. If Big City has not made any indication that it will enter the market, Hometown is not required to consider disclosure. However, if Big City has formally announced an entrance or has already entered the market, the situation already exists and Hometown should consider whether the other criteria are met to require disclosure.

While the "existing condition" requirement helps to narrow the range of estimates that meets the criterion, the range is still very broad. That is primarily because of the use of the term *reasonably possible*, which has the same meaning in FASB ASC 275 (formerly SOP 94-6) as it does in FASB ASC 450 (formerly SFAS No. 5, *Accounting for Contingencies*). FASB ASC 450-20-20 (formerly SFAS No. 5) provides the following definitions:

- *Probable.* The future event or events are likely to occur.

- *Reasonably Possible.* The chance of the future event or events occurring is more than remote but less than likely.

- *Remote.* The chance of the future event or events occurring is slight.

Deciding where to apply the threshold within that range is very subjective. Accountants must apply judgment based on the individual circumstances of each situation. Disclosure should generally be considered more closely when a condition, situation, or set of circumstances makes an estimate more susceptible to change than it ordinarily would be. In addition, the more critical an estimate is to the financial statements, the more likely it is that disclosure is needed. As a practical matter, the disclosure can be used to provide an early warning to financial statement users that certain estimates, based on the best information available, are still somewhat soft.

If an estimate meets the criteria for disclosure, the disclosure must:

- Describe the nature of the uncertainty, and

- Indicate that it is at least reasonably possible that a change in the estimate will occur in the near term (period of time not to exceed one year). However, specific use of the term *reasonably possible* is not required.

Using the example introduced above, the following disclosure might be made:

> Recently, a large public construction company entered Hometown's primary market of Amarillo, Texas. Due to potential market loss, it is reasonably possible that the amount of the Company's deferred tax asset that it expects to realize might change in the near future.

Best practices indicate that it is good practice to document conclusions about significant estimates that could change in the near term. Such documentation can be informal and can be done, for example, on the relevant workpaper or in a separate memo.

Should Construction Companies Using the Percentage-of-completion Method Always Include a Significant Estimate Disclosure? The answer to that question is very subjective. Nowhere in GAAP does it suggest that certain industries have certain types of estimates that will *always* require disclosure under the "certain significant estimates" guidance. GAAP only requires that the *general* disclosure about estimates be made in every case. Additionally, FASB ASC 605-35-55-3 and 55-10 (formerly Paragraphs A-37 and A-42 of SOP 94-6) suggest that such a disclosure is not necessary if the contractor uses the percentage-of-completion method *and* has a history of making reasonably dependable estimates.

However, many accountants believe that in most cases it is *at least reasonably possible* that a material change in the estimates used in the percentage-of-completion method of accounting will occur in the near term. They believe that a significant estimates disclosure is *not needed* only where the effect would *clearly* not be material to the financial statements. They also believe the disclosure to be relatively simple and that it may provide some protection for the practitioner.

A *significant estimates* disclosure is recommended for contractors unless it can be clearly concluded that a material change in contract estimates is not at least reasonably possible. The following illustrates such a disclosure.

> The Company recognizes revenues from fixed-price construction contracts using the percentage-of-completion method, measured by the percentage of cost incurred to date to management's estimated total cost for each contract. That method is used because management considers total cost to be the best available measure of progress on the contracts. Because of the inherent uncertainties in estimating costs, it is at least reasonably possible that the estimates used will change within the near term. [In some instances, it may be appropriate to refer to "costs and revenues" in the preceding sentence.]

Even if this disclosure is used, it is still necessary to highlight other specific conditions, situations, or circumstances existing at the balance sheet date that could significantly change an estimate in the near term and have a material impact on the financial statements.

Vulnerability Resulting from Concentrations. A company can subject itself to increased risks solely due to a lack of diversification, such as in operating markets, number of customers, or suppliers of raw materials. That lack of diversification is referred to as *concentrations*. FASB ASC 275-10-50 (formerly SOP 94-6) requires that concentrations be disclosed if certain criteria are met. The types of concentrations that must be *considered* for disclosure include the following:

- Concentrations in the volume of business transacted with a particular customer, supplier, or lender.
- Concentrations in revenue from particular products or services.
- Concentrations in the available sources of materials, labor, or services; or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographic area in which an entity conducts its operations.

A concentration is of concern when it involves something that cannot be easily replaced. If, for example, a contractor purchases most of its lumber from a single supplier, that is not a concentration unless the supplier cannot be easily replaced. Disclosure of concentrations is only required when all of the following criteria are met:

- A concentration exists at the financial statement date.

- The concentration makes the company vulnerable to the risk of a near-term severe impact.
- It is at least reasonably possible that the events that could cause the severe impact will occur in the near term (within the next year).

The criteria are similar in some ways and use some of the same wording as the criteria for disclosing certain significant estimates. (See paragraph .) For example, the concentration must meet "existing condition" and "at least reasonably possible" criteria. Also, the criteria are to be considered using "information known to management before the financial statements are issued or are available to be issued."

For concentrations meeting the disclosure criteria, disclosures must include information that is adequate to inform financial statement users of the general nature of the risk associated with the concentration. Additional specific disclosures are required for concentrations of labor subject to collective bargaining agreements and for foreign operations if they meet the criteria described above. The following are examples of disclosures that meet these requirements:

Concentration of Customers and Geographic Location

Southwest R&B, Inc. constructs roads and bridges for states located in the southwestern United States. Approximately 70% of the Company's contracts are with the states of Texas and Arkansas.

Concentration of Source of Supply of Labor

Eighty percent of Electrical Subcontractors, Inc.'s labor force are members of the United Electrical Workers Union. The Company's contract with the union is subject to renegotiation during 20XX. The Company's other workers are not represented by a union.

Changes In Estimates

Determining the percentage-of-completion for each uncompleted long-term contract at year-end involves estimation. FASB ASC 250-10 (formerly SFAS No. 154) requires disclosure of the change in accounting estimate if the effect is material to either revenue or cost. As contractors adjust the estimates related to uncompleted contracts, the cumulative effect of the revised estimates should be recognized in the period of change. Contractors and their auditors need to be aware of this required disclosure.

Comprehensive Income

FASB ASC FASB ASC 220-10 (formerly SFAS No. 130, *Reporting Comprehensive Income*), establishes financial statement presentation and disclosure requirements relating to comprehensive income. The following paragraphs provide an overview of the requirements.

Definition of Comprehensive Income. Comprehensive income represents the change in a company's equity during a period from transactions and events other than those resulting from investments by or distributions to owners. Comprehensive income refers to net income plus other comprehensive income (i.e., certain revenues, expenses, gains, and losses that are reported as separate components of stockholders' equity rather than in net income). Under FASB ASC 220-10-55-2 (formerly SFAS No. 130, Paragraph 17), other comprehensive income includes:

- Unrealized gains and losses on debt and equity securities classified as available-for-sale.
- Amounts recognized in other comprehensive income for debt securities classified as available-for-sale and held-to-maturity related to an other-than-temporary impairment.
- Gains or losses related to pension or other postretirement benefits.
- Prior-service costs or credits related to pension or other postretirement benefits.

- Transition assets or obligations related to pension or other postretirement benefits.
- Foreign currency translation adjustments and gains and losses from certain foreign currency transactions.
- The effective portion of the gain or loss on derivative instruments designated as cash flow hedging instruments (including qualifying foreign currency cash flow hedges).

Items other than net income that are included in comprehensive income are referred to collectively as "other comprehensive income."

Financial Statement Presentation Requirements. All components of comprehensive income should be reported in a full set of financial statements in the period in which they are recognized. *Companies that have no items of other comprehensive income are not required to report comprehensive income.* The authors believe that many small to mid-sized contractors will not have comprehensive income.

When displaying comprehensive income is required, the following are examples of acceptable alternatives for displaying comprehensive income:

- A combined statement of income and comprehensive income.
- A separate statement of comprehensive income.
- A statement of changes in stockholders equity that includes comprehensive income.

Comprehensive income should be reported net of related tax effects. This can be done by presenting components of other comprehensive income net of taxes or by presenting pretax components with a total tax expense or benefit relating to other comprehensive income.

Accumulated other comprehensive income should be reported in the equity section of the balance sheet separate from retained earnings and additional paid-in capital. Accumulated balances for each component of other comprehensive income should be reported in the balance sheet, the statement of changes in stockholders' equity, or the notes.

Reclassification Adjustments. Adjustments to comprehensive income will be necessary to avoid double counting items displayed in net income in the current period that were included in other comprehensive income during prior periods. These are called reclassification adjustments.

Illustrative Financial Statement Presentation. The following illustrates the placement of the primary captions in a combined statement of income and comprehensive income, which is one of the three acceptable methods of presentation. The statement of comprehensive income may be presented as a continuation of the income statement, with net income serving as the element that joins the two statements together.

ABC CONSTRUCTION COMPANY, INC.
STATEMENT OF INCOME AND COMPREHENSIVE INCOME
YEAR ENDED DECEMBER 31, 20XX

(NOTE: the key captions of the income statement have been omitted)

NET INCOME			$ 2,000,300
OTHER COMPREHENSIVE INCOME, NET OF TAX:			
Foreign currency translation adjustments		60,000	
Unrealized gains on securities:			
Unrealized holding gains arising during the period	150,000		
Less: reclassification adjustment	(30,000)		
		120,000	
OTHER COMPREHENSIVE INCOME			180,000
TOTAL COMPREHENSIVE INCOME			$ 2,180,300

This illustrated statement presents the components of other comprehensive income net of tax. Alternatively, they could be displayed before tax with one amount shown for aggregate income tax expense.

Disclosure Requirements. GAAP requires the following disclosures:

- Reclassification adjustments, unless displayed on the financial statement that reports comprehensive income.
- The amount of income tax expense or benefit allocated to each component of other comprehensive income, unless displayed on the financial statement that reports comprehensive income.
- The accumulated balance for each component of other comprehensive income, unless displayed in the balance sheet or statement of changes in equity.

Subsequent Events

FASB ASC 855-10 (formerly SFAS No. 165, *Subsequent Events*) includes accounting and disclosure standards on subsequent events that formerly resided in auditing standards. The new standard does not apply to subsequent events specifically addressed in other applicable GAAP, including FASB ASC 740-10-55 (formerly FIN 48, "Accounting for Uncertainty in Income Taxes"), FASB ASC 260-10-50 (formerly SFAS No. 128, *Earnings per Share*) or FASB ASC 450-20-50 and 20-5520-55 (formerly SFAS No. 5, *Accounting for Contingencies*). The new standard is effective for periods ending after June 15, 2009, and should be applied prospectively.

The key to proper treatment of subsequent events is identifying the event or condition and determining when the event or condition arose.

Recognized (Type I). *Recognized* (known as type I in prior standards) subsequent events are those that *provide additional evidence* about conditions that existed at the balance sheet date and that affect the estimates inherent in preparing the financial statements. The proper accounting treatment for those events is *adjustment* of the financial statements. In other words, new information available after the balance sheet date affects the estimates that were used in preparing the financial statements and that information is considered in adjusting the financial statements at the balance sheet date. For example, a litigation accrual would be adjusted to the settlement amount if the event that gave rise to the litigation took place before the balance sheet date and settled after the balance sheet date but before the financial statements are issued or available to be issued.

Nonrecognized (Type II). *Nonrecognized* (known as type II in prior standards) subsequent events are events that provide evidence about conditions that did not exist at the balance sheet date but arose after that date but before the financial statements are issued or available to be issued. Such events should not be recognized in the financial statements but should be disclosed if considered necessary to keep the financial statements from being misleading. The proper accounting treatment for those events is disclosure in the financial statements of the nature of the event and an estimate of its financial effect, or disclosure that such an estimate cannot be made. Exceptions to the balance sheet date cutoff for adjustment versus disclosure are stock dividends, stock splits, or reverse splits after the balance sheet date but before the financial statements are issued or available to be issued. Those events should be given effect in the balance sheet with appropriate disclosure.

According to FASB ASU 2010-09, *Subsequent Events, Amendments to Certain Recognition and Disclosure Requirements*, issued in February 2010 and generally effective upon issuance, unless an entity is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market, an entity should evaluate subsequent events through the date that the financial statements are available to be issued. If an entity is not an SEC filer, then such entity must disclose in the financial statements the date through which subsequent events were evaluated and whether that date is the date the financial statements are issued or are available to be issued. Additionally, if a non-SEC filer issues revised financial statements (that is, financial statements that have been revised for a correction of an error or retrospective application of GAAP), the entity is required to disclose the dates through which subsequent events have been evaluated for both the issued or available to be issued financial statements and the revised financial statements.

When Financial Statements are *Issued* and *Available to be Issued*. According to FASB ASC 855-10-20 (formerly SFAS No. 165, Paragraphs 5 and 6), financial statements are *issued* when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. Financial statements are *available to be issued* when they are complete in a form and format that complies with GAAP and all approvals necessary for their issuance have been obtained, such as from management, the board of directors, and/or significant shareholders. Based on the guidance presented in the preceding paragraph, the date that should be used by construction contractors that are not SEC filers is the date the financial statements are available to be issued.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. ARB No. 43, Chapter 3A (FASB ASC 210-10), defines *current assets* as cash and other assets that are reasonably expected to be realized in cash or sold or consumed during _____, or within the company's normal operating cycle if longer.

    a. A 180 day period.

    b. One year.

    c. An 18 month period.

    d. Any reasonable period of time.

20. Generally, an unclassified balance sheet is *preferred* in which of the following circumstances?

    a. Clothing manufacturer whose operating cycle is 180 days.

    b. A small contractor with an operating cycle of 270 days.

    c. A brewery that has an operating cycle of 18 months.

    d. Real estate developer with an operating cycle of 24 months.

21. How should contracts entered into for speculative or trading purposes account for weather derivatives?

    a. They should be recorded at fair value.

    b. They should use the intrinsic value method of accounting.

22. Construction contractors ordinarily see fair value measurement requirements in which of the following areas?

    a. Short-lived assets.

    b. Short-term receivables.

    c. Equity securities.

    d. Short-term debt.

23. Which of the following statements regarding derivatives is most accurate?

    a. The embedded derivative is generally the most common to small and midsize contractors.

    b. How the change in fair value of derivatives is accounted for is based primarily on whether hedge accounting is elected.

24. Which of the following should occur when a guarantee is issued?

    a. The contingent liability should be recorded when the amount is reasonably estimated and it is certain that the loss will be incurred.

    b. The fair value of a guarantee in a stand-along, arm's length transaction with a third party is the value of the guarantee by market-analysis.

    c. The guarantor is required to perform when specific triggering events occur in a contingent obligation and perform per the terms of the guarantee in a noncontingent obligation.

    d. The fair value of a guarantee in an arm's length transaction with a third party that includes several elements is the premium received by the guarantor.

25. FASB ASC 410-30 (formerly SOP 96-1) provides which of the following related to accounting for environmental cleanup costs and liabilities?

    a. Primary guidance on accounting for environmental cleanup costs and liabilities.

    b. Accounting/reporting guidance for environmental remediation obligations related to normal operation of a long-lived asset.

    c. Specific guidance for disclosing environmental remediation liabilities.

26. According to FASB ASC 410-30-25-18 (formerly EITF Issue No. 90-8), environmental cleanup costs should be capitalized in all the following circumstances **except**:

    a. The costs are not recoverable.

    b. Recoverable costs are incurred for sale property being held for sale.

    c. Recoverable costs extend the life of property owned by the company.

    d. Recoverable costs prevent environmental contamination that might result from future activities.

27. If a construction contractor must deal with a contaminated project site, how should the environmental cleanup costs and liabilities by accounted for?

    a. Environmental cleanup costs should generally be charged to expense and liabilities accrued.

    b. Environmental cleanup costs would generally be accounted for like costs under any other long-term contract.

28. Environmental remediation liabilities should provide for incremental direct costs and compensation and benefits costs. Which of the following is classified as compensation and benefits costs?

    a. Costs related to the feasibility study or remedial investigation.

    b. Government oversight costs (i.e. fines).

    c. The cost of equipment that has no alternative uses and is dedicated to the remedial actions.

    d. Remediation activities that involve technical employees.

29. FASB ASC 360-10-15-4 and 15-5 (formerly SFAS No. 144) applies to which of the following recognized long-lived assets?

    a. Financial instruments.

    b. Capital leases of lessees.

    c. Goodwill.

30. For S corporations, additional disclosures that are not required by GAAP, but should be considered, include retained earnings and changes in retained earnings that are segregated into several components. Which of those components, listed below, represent undistributed tax basis earnings as of the balance sheet date arising *after the date of conversion* to an S corporation?

    a. Accumulated Adjustments Account.

    b. Tax Temporary Adjustments Account.

    c. Accumulated Undistributed Non-taxable Income and Income Previously Taxed.

31. Disclosure of which of the following risks and uncertainties that could significantly affect the amounts reported in the financial statements is required only for estimates and concentrations that meet specified criteria?

    a. Nature of operations.

    b. Use of estimates in financial statement preparation.

    c. Vulnerability resulting from concentrations.

32. Which of the following is accurate regarding GAAP requirements for financial statements?

    a. Only certain specified financial statements should include a description of the major products or services the reporting entity sells or provides.

    b. GAAP has an optional provision for disclosure of the entity's principal markets and where those markets are located.

    c. When an entity operates in more than one business, only the relative importance of the principal business must be included in disclosures.

    d. Relative importance does not have to be quantified, and can be described by terms like *predominately*, *about equally*, or *major*.

33. For estimates that require disclosure, the disclosure must indicate that it is at least reasonably possible that a change in the estimate will occur in the near-term. Near-term is defined as a period of time not to exceed:

    a. 6 months.

    b. 9 months.

    c. One year.

    d. Two years.

34. *Comprehensive income* is defined as the change in a company's equity during a period from any of the following transactions and events **except**:

    a. Prior service costs or credits associated with pension or other postretirement benefits.

    b. Gains or losses associated with pension or other postretirement benefits.

    c. Those transactions or events that result from investments by owners.

    d. Unrealized gains and losses on marketable securities available-for-sale.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. FASB ASC 210-10 (formerly ARB No. 43, Chapter 3A), defines *current assets* as cash and other assets that are reasonably expected to be realized in cash or sold or consumed during _____, or within the company's normal operating cycle if longer. **(Page 53)**

    a. A 180 day period. [This answer is incorrect. Current assets are defined as cash and other assets reasonably expected to be realized in cash or sold or consumed during a period of time that extends beyond 180 days.]

    b. One year. [This answer is correct. Per FASB ASC 210-10, current assets are, by definition, cash and other assets that are reasonably expected to be realized in cash or sold or consumed during *one year*, or within the company's normal operating cycle if longer than a year.]

    c. An 18 month period. [This answer is incorrect. FASB ASC 210-10 defines current assets as cash and other assets reasonably expected to be realized in cash or sold or consumed during a period of time that is shorter than 18 months.]

    d. Any reasonable period of time. [This answer is incorrect. FASB ASC 210-10 (formerly ARB No. 43, Chapter 3A), defines current assets as cash and other assets that are reasonably expected to be realized in cash or sold or consumed during a specified timeframe, or within the company's normal operating cycle if longer, not just within "any reasonable period of time."]

20. Generally, an unclassified balance sheet is *preferred* in which of the following circumstances? **(Page 53)**

    a. Clothing manufacturer whose operating cycle is 180 days. [This answer is incorrect. An unclassified balance sheet is not preferable for a clothing manufacturer whose operating cycle is only 180 days as stated in FASB ASC 210-10, (formerly ARB No. 43, Chapter 3A).]

    b. A small contractor with an operating cycle of 270 days. [This answer is incorrect. A small contractor with an operating cycle of 270 days does not meet the criteria whereby use of an unclassified balance sheet is preferable as stated in FASB ASC 210 (formerly ARB No. 43, Chapter 3A). Although an unclassified balance sheet may be presented, a classified balance is preferable and is normally presented in practice.]

    c. A brewery that has an operating cycle of 18 months. [This answer is correct. In most industries, an unclassified balance sheet is preferable in cases where the operating cycle exceeds one year. Since the operating cycle for the brewery is 18 months, an unclassified balance sheet is preferable.]

    d. Real estate developer with an operating cycle of 24 months. [This answer is incorrect. Although a real estate developer is in the construction business and has an operating cycle of 24 months, the most common practice is to classify all contract-related assets and liabilities as current on the operating cycle concept and to classify other assets and liabilities based on guidance in FASB ASC 210 (formerly ARB No. 43).]

21. How should contracts entered into for speculative or trading purposes account for weather derivatives? **(Page 56)**

    a. They should be recorded at fair value. [This answer is correct. According to FASB ASC 815-45-30 (formerly EITF No. 99-2), contracts entered into for speculative or trading purposes should be recorded at fair value and subsequent fair value changes should be reported in earnings.]

    b. They should use the intrinsic value method of accounting. [This answer is incorrect. FASB ASC 815-45-30 (formerly EITF No. 99-2) provides that contracts entered into for *nontrading* purposes should be accounted for using the intrinsic value method of accounting.]

22. Construction contractors ordinarily see fair value measurement requirements in which of the following areas? **(Page 57)**

    a. Short-lived assets. [This answer is incorrect. According to GAAP, one area construction contractors commonly see fair value measurement requirements in is *long-lived* assets.]

    b. Short-term receivables. [This answer is incorrect. According to GAAP, *long-term* receivables (retentions) are one area where construction contractors often see fair value measurement.]

    c. Equity securities. [This answer is correct. Per GAAP, air value measurement requirements are normally seen by construction contractors in equity and debt securities.]

    d. Short-term debt. [This answer is incorrect. According to GAAP, construction contractors many times see fair value measurement requirements in *long-lived* debt.]

23. Which of the following statements regarding derivatives is most accurate? **(Page 58)**

    a. The embedded derivative is generally the most common to small and midsize contractors. [This answer is incorrect. The most common form of derivative to small and midsize contractors is the interest rate swap.]

    b. How the change in fair value of derivatives is accounted for is based primarily on whether hedge accounting is elected. [This answer is correct. Accounting for the change in the fair value of derivatives depends primarily on whether hedge accounting is elected. If hedge accounting is elected, generally the portion of the change in fair value that is effective as a hedge is recorded as other comprehensive income and the ineffective portion is reported as earnings. If hedge accounting is not elected, all of the change is reported in earnings.]

24. Which of the following should occur when a guarantee is issued? **(Page 59)**

    a. The contingent liability should be recorded when the amount is reasonably estimated and it is certain that the loss will be incurred. [This answer is incorrect. The liability should be recorded when the amount is reasonably estimated, but the loss only has to be probable to occur, not certain.]

    b. The fair value of a guarantee in a stand-alone, arm's length transaction with a third party is the value of the guarantee by market-analysis. [This answer is incorrect. The fair value of a guarantee in a stand-alone, arm's length transaction with a third party should generally be the premium received or receivable by the guarantor.]

    c. The guarantor is required to perform when specific triggering events occur in a contingent obligation and perform per the terms of the guarantee in a noncontingent obligation. [This answer is correct. When a guarantee is issued, the guarantee is obligated in two ways, (a) a contingent obligation to perform when a specified triggering event occurs, and (b) a noncontingent obligation to be ready to perform during the term of the guarantee if one or more event occurs.]

    d. The fair value of a guarantee in an arm's length transaction with a third party that includes several elements is the premium received by the guarantor. [This answer is incorrect. The fair value of a guarantee in an arm's length transaction with a third party that includes several elements may be measured by comparing similar transactions where the value of the guarantee was determined.]

25. FASB ASC 410-30 (formerly SOP 96-1) provides which of the following related to accounting for environmental cleanup costs and liabilities? **(Page 60)**

    a. Primary guidance on accounting for environmental cleanup costs and liabilities. [This answer is incorrect. Primary guidance covering general guidance on accruing liabilities for loss contingencies is provided by FASB ASC 450-20 (formerly SFAS No. 5, *Accounting for Contingencies*).]

    b. Accounting/reporting guidance for environmental remediation obligations related to normal operation of a long-lived asset. [This answer is incorrect. Accounting and reporting guidance for environmental remediation obligations arising from the normal operation of a long-lived asset and which is associated with its retirement is provided in FASB 410-20 (formerly SFAS No. 143, *Accounting for Asset Retirement Obligations*).]

    c. Specific guidance for disclosing environmental remediation liabilities. [This answer is correct. FASB ASC 410-30 (formerly SOP 96-1) provides specific guidance for recognizing, measuring, and disclosing environmental remediation liabilities.]

26. According to FASB ASC 410-30-25-18 (formerly EITF Issue No. 90-8) environmental cleanup costs should be capitalized in all the following circumstances **except**: **(Page 61)**

    a. The costs are not recoverable. [This answer is correct. According to FASB ASC 410-30-25-18 (formerly EITF Issue No. 90-8) environmental cleanup costs should not be capitalized unless the costs are recoverable.]

    b. Recoverable costs are incurred for sale property being held for sale. [This answer is incorrect. If recoverable costs are incurred for sale property that is currently held for sale, environmental cleanup costs should be capitalized.]

    c. Recoverable costs extend the life of property owned by the company. [This answer is incorrect. Environmental cleanup costs should be capitalized if recoverable costs extend the life, increase the capacity, or improve the safety or efficiency of property owned by the company.]

    d. Recoverable costs prevent environmental contamination that might result from future activities. [This answer is incorrect. If recoverable costs lessen or prevent environmental contamination that has not yet occurred but might otherwise result from future operations or activities, EITF Issue No. 90-8 states that environmental cleanup costs should be capitalized.]

27. If a construction contractor must deal with a contaminated project site, how should the environmental cleanup costs and liabilities by accounted for? **(Page 61)**

    a. Environmental cleanup costs should generally be charged to expense and liabilities accrued. [This answer is correct. Environmental cleanup costs for a *project contamination* where a contractor associated with a contaminated project site generally should be charged to expense and liabilities accrued in accordance with FASB ASC 450-20 (formerly SFAS No. 5) and FASB ASC 410-30 (formerly SOP 96-1).]

    b. Environmental cleanup costs would generally be accounted for like costs under any other long-term contract. [This answer is incorrect. Environmental cleanup costs would generally be accounted for like costs under any other long-term contract in the case of a *cleanup contract* where a contractor enters into a contract to clean up existing contamination at a project site.]

28. Environmental remediation liabilities should provide for incremental direct costs and compensation and benefits costs. Which of the following is classified as compensation and benefits costs? **(Page 63)**

    a. Costs related to the feasibility study or remedial investigation. [This answer is incorrect. Costs related to the feasibility study or remedial investigations are incremental direct costs.]

    b. Government oversight costs (i.e., fines). [This answer is incorrect. Government oversight costs, such as fines, are incremental direct costs.]

    c. The cost of equipment that has no alternative uses and is dedicated to the remedial actions. [This answer is incorrect. Incremental direct costs include costs of equipment dedicated to remedial actions and having no alternative use.]

    d. Remediation activities that involve technical employees. [This answer is correct. Compensation and benefit costs are for employees who devote significant time directly to remediation activities such as technical employees involved with remediation activities, and internal legal staff involved with determining the extent of remedial actions required, the type of remedial actions to be used, and the allocation of costs among PRPs.]

29. FASB ASC 360-10-15-4 and 15-5 (formerly SFAS No. 144) applies to which of the following recognized long-lived assets? **(Page 65)**

    a. Financial instruments. [This answer is incorrect. Financial instruments are not recognized long-lived assets and, therefore, FASB ASC 360-10-15-4 (formerly SFAS No. 144) does not apply.]

    b. Capital leases of lessees. [This answer is correct. Capital leases of lessees is a recognized long-lived asset and FASB ASC 360-10-15-4 (formerly SFAS No. 144) applies.]

    c. Goodwill. [This answer is incorrect. FASB ASC 360-10-15-4 (formerly SFAS No. 144) does not apply to goodwill since goodwill is not a recognized long-lived asset.]

30. For S corporations, additional disclosures that are not required by GAAP, but should be considered, include retained earnings and changes in retained earnings that are segregated into several components. Which of those components, listed below, represent undistributed tax basis retained earnings as of the balance sheet date arising *after the date of conversion* to an S corporation? **(Page 67)**

    a. Accumulated Adjustments Account. [This answer is correct. The accumulated adjustments account is the component that essentially represents undistributed tax basis retained earnings as of the balance sheet date arising after the date of conversion to an S corporation. It excludes temporary differences that originate or reverse after the date of conversion and only includes permanent differences relating to nondeductible expenses incurred after the date of conversion.]

    b. Tax Temporary Adjustments Account. [This answer is incorrect. The tax temporary adjustments account is the component that represents cumulative temporary differences as of the balance sheet date. The account is adjusted for temporary differences that originate and reverse after the conversion.]

    c. Accumulated Undistributed Non-taxable Income and Income Previously Taxed. [This answer is incorrect. The accumulated undistributed non-taxable income and income previously taxed amount is the component that represents undistributed tax basis earnings at the date of conversion plus other amounts that consist primarily of tax-exempt income since conversion.]

31. Disclosure of which of the following risks and uncertainties that could significantly affect the amounts reported in the financial statements is required only for estimates and concentrations that meet specified criteria? **(Page 71)**

    a. Nature of operations. [This answer is incorrect. According to FASB ASC 275, the nature of operations is required for all financial statements, not just for the estimates and concentrations that meet specific criteria.]

    b. Use of estimates in financial statement preparation. [This answer is incorrect. The use of estimates in financial statement preparation is required for all financial statements under FASB ASC 275 not just for the estimates and concentrations that meet specific criteria.]

    c. Vulnerability resulting from concentrations. [This answer is correct. Under FASB 275 disclosure of risks and uncertainties are required for certain significant estimates and vulnerability resulting from concentrations that meet specified criteria.]

32. Which of the following is accurate regarding GAAP requirements for financial statements? **(Page 72)**

    a. Only certain specified financial statements should include a description of the major products or services the reporting entity sells or provides. [This answer is incorrect. According to FASB ASC 275, *all* financial statements should include a description of the major products or services that the reporting entity sells or provides.]

    b. GAAP has an optional provision for disclosure of the entity's principal markets and where those markets are located. [This answer is incorrect. All financial statements require disclosure of the entity's principal markets and the location of those markets under FASB ASC 275.]

    c. When an entity operates in more than one business, only the relative importance of the principal business must be included in disclosures. [This answer is incorrect. When an entity operates in more than one business, disclosures must include the relative importance of each business and on what basis the relative importance will be determined.]

    d. Relative importance does not have to be quantified, and can be described by terms like *predominately, about equally, or major*. [This answer is correct. Relative importance can be based on assets, revenues, or net income, and does not have to be quantified under FASB ASC 275.]

33. For estimates that require disclosure, the disclosure must indicate that it is at least reasonably possible that a change in the estimate will occur in the near-term. Near-term is defined as a period of time not to exceed which of the following? **(Page 73)**

    a. 6 months. [This answer is incorrect. Near-term is a period of time that can be greater than just 6 months as stated in FASB ASC 275.]

    b. 9 months. [This answer is incorrect. Near-term is a period of time that can be greater than just 9 months as stated in FASB ASC 275.]

    c. One year. [This answer is correct. The correct period of time classified as near-term for estimates that require disclosure is a timeframe not to exceed one year.]

    d. Two years. [This answer is incorrect. Near-term is not defined as a period of two years as stated in FASB ASC 275.]

34. *Comprehensive income* is defined as the change in a company's equity during a period from any of the following transactions and events **except**: **(Page 74)**

    a. Prior-service costs or credits associated with pension or other postretirement benefits. [This answer is incorrect. Per FASB ASC 220-10-55-2, comprehensive income includes net income and other changes in assets and liabilities such as prior-service costs or credits related to pension or other postretirement benefits.]

    b. Gains or losses associated with pension or other postretirement benefits. [This answer is incorrect. Per FASB ASC 220-10-55-2, gains or losses related to pension or other postretirement benefits that result in a change in a company's equity during a period is defined as comprehensive income.]

    c. Transactions or events that result from investments by owners. [This answer is correct. Transactions that result from investments by owners or distributions to owners do not meet the criteria for inclusion as comprehensive income that results in a change in a company's equity during a period.]

    d. Unrealized gains and losses on marketable securities available-for-sale. [This answer is incorrect. Unrealized gains and losses on marketable securities available-for-sale are another example of transactions and events that change a company's equity during a period and meet the requirements to be classified as comprehensive income per FASB ASC 220-10-55-2.]

INVESTMENTS IN VENTURES

Contractors frequently participate jointly with other entities to share risks, combine financial and other resources, or obtain financing or bonding. Ventures are generally organized in one of the following legal forms:

a. Corporation.

b. General or limited partnership.

c. Joint venture.

There are several different methods of presenting a contractor's interest in a venture. The more common methods are as follows:

a. Consolidation.

b. Equity method, including the little-used expanded equity method.

c. Cost method.

d. Prorata combination.

Consolidation

Consolidated financial statements present the financial position, results of operations, and cash flows of a contractor and its majority-owned venture as if the two were a single economic entity. The ownership by one entity of a controlling interest in another entity represents two separate legal entities but, in substance, a single economic or accounting entity. FASB ASC 810-10-10-1, and 15-8 (formerly ARB No. 51, as amended) states that "there is a presumption that consolidated statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one of the entities in the group directly or indirectly has a *controlling financial interest* in the other entities . . . (The) usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of over 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation." The only exception to the requirement to consolidate majority-owned ventures is if control does not rest with the majority owners, for example, when a subsidiary is in legal reorganization or bankruptcy or operates under certain foreign exchange or governmental restrictions.

The power to control a partnership may exist even if the contractor owns less than 50% of the voting interest. If voting interest is not clearly indicated, ownership of a majority interest in profits or losses will generally indicate control. If the contractor has the ability to exercise control, for example, by contract, lease, agreement with other partners, or by court decree, the financial statements of the contractor and the partnership should be consolidated—even if the ownership percentage is 50% or less. On the other hand, a contractor who owns more than 50% of a partnership may not have the power to control if major decisions must be approved by one or more of the other partners. A noncontrolling investor in a partnership should not use the consolidation method even if the investor owns a majority of the partnership. Generally, an investor in a limited partnership is less likely to have a controlling interest or to exert significant influence than an investor in a general partnership. However, all facts and circumstances should be considered in each situation.

In consolidating two companies, the assets, liabilities, revenues, and expenses of the parent and the subsidiary are added together. Intra-entity balances and transactions, including intra-entity profits, should be eliminated. When reporting a noncontrolling interest in the consolidated statement of financial position, FASB ASC 810-10-45-16 (formerly SFAS No. 160) requires that the noncontrolling interest be treated as a component of consolidated equity, separate from the parent's equity. Additionally, when reporting a noncontrolling interest in the consolidated results of operations, the consolidated net income attributable to both the parent and the noncontrolling interest should be presented, and the consolidated net income attributable to the parent and the noncontrolling interest should be disclosed on the face of the consolidated income statement. (Some banks request that consolidating financial

statements be included as supplemental schedules to show the entities as they originally existed prior to consolidation.)

Equity:	
Construction Co. shareholders' equity	
Common stock, $1 par	$ 1,000
Retained earnings	167,631
Total Construction Co. shareholders' equity	168,631
Noncontrolling interest	12,325
Total equity	$ 180,956

Illustrative Statement of Income Presentation of a Noncontrolling Interest. The following consolidated statement of income illustrates the requirements in SFAS No. 160 that the amounts of consolidated net income and the net income attributable to Construction Co. and the noncontrolling interest be presented separately on the face of the statement of income.

Contract revenues earned	$ 335,242
Cost of revenues earned	266,776
Gross profit	68,466
General and administrative expenses	50,165
Income from operations	18,301
Income taxes	3,314
Net income	14,987
Add: Net loss attributable to the noncontrolling interest	2,800
Net income attributable to Construction Co.	$ 17,787

Income Tax Considerations. Consolidation rules for federal income tax purposes differ from GAAP requirements. IRS regulations require an 80% ownership for consolidated tax returns to be filed. Thus, in some cases, consolidated financial statements will be required by GAAP even though the companies do not qualify to file consolidated tax returns.

Variable Interest Entities

The following information provides guidance on considering the need to include in the financial statements of small and midsize construction contractors the consolidated financial results of entities considered to be variable interest entities. The guidance in this section is designed to provide an overview. *PPC's Guide to Related Parties (Including Variable Interest Entities)* provides detailed guidance.

The guidance on accounting for variable interests in variable interest entities is included with all of the authoritative consolidation accounting guidance in FASB ASC 810. Each section of consolidation accounting guidance in the Codification establishes the general principles, and then provides guidance on how to apply those principles to a variable interest in a variable interest entity. For example, FASB ASC 810-10-25 provides guidance on recognition considerations; that section contains a separate subsection for recognition for a variable interest in a variable interest entity.

When to Consider Whether the Reporting Entity Has a Variable Interest in a Variable Interest Entity. A small or midsize nonpublic construction contractor should consider whether it has a variable interest in a variable interest entity if it has one of the following relationships with another entity:

a. the reporting entity (the contractor), its related parties, or both participated significantly in the design or redesign of the entity (the potential VIE);

b. the entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties;

c. the reporting entity and its related parties provide more than half of the entity's subordinated financial support; or

d. the activities of the entity are primarily related to securitization or other forms of asset-backed financings or single-lessee leasing arrangements.

Many small and midsize nonpublic entities have the first type of relationship with another entity. Typically, an individual has the majority voting equity interest in both the reporting entity and the other entity. However, the reporting entity may hold a majority or minority voting equity interest in the other entity. Examples of the first type of relationship with another small or midsize nonpublic entity are—

a. The holder of a majority voting equity interest in an operating entity may form a separate entity to acquire real estate or equipment to lease to the operating entity.

b. The holder of a majority voting equity interest in a homebuilder may form a separate entity to acquire and develop residential lots for sale to the homebuilder.

c. A general contractor may form a limited liability company with a subcontractor to provide services almost exclusively to the general contractor.

A relationship that requires the reporting entity to consider whether it has a variable interest in a variable interest entity does *not* by itself mean that the reporting entity is required to include the consolidated financial results of the entity in its financial statements. A number of other considerations must be made before the reporting entity can decide whether consolidation is required.

Other Considerations. Although the authoritative consolidation accounting literature does not define *controlling financial interest*, it establishes the presumption that a majority voting equity interest in an entity gives the holder a controlling financial interest in the entity. It also specifically acknowledges the possibility that the presumption may be overcome.

Losses and Benefits. The authoritative literature on accounting for a variable interest in a variable interest entity established the notion that the determination of who has a controlling financial interest in another entity depends partly on who bears the risk of things going worse than expected and who reaps the benefits of things going better than expected. The effect of things going worse than expected is generally referred to as either *losses* or *expected losses*. The effect of things going better than expected is generally referred to as either *benefits* or *expected residual returns*. The notion of losses and benefits is therefore not the same as measures of operating performance such as results of operations or cash flows from operating activities. Instead, the notions of losses and benefits look at who assumes the risks and receives the rewards of variability from expected results.

The authoritative literature only specifically mentions *significance* of losses and benefits in the determination of whether a party holds a controlling financial interest in a variable interest entity. In that context, the guidance requires consideration of losses and benefits that could *potentially* be significant to the variable interest entity. Therefore, the determination is not made based on conditions that exist at the time the entity is formed but instead is made based on the assumption that future losses and benefits would be significant.

Sufficiency of Equity. The notion of the sufficiency of the equity investment looks at who bears the risk of losses.

a. If the equity investors alone bear the risk of things going worse than expected—the risk of losses—equity is sufficient.

b. If other parties share that risk, equity is not sufficient.

Whether equity is sufficient to finance the entity's activities *without additional subordinated financial support* depends on whether the equity investors alone bear the risk of loss or whether others share that risk. If other parties share that risk, they are considered to be providing *additional subordinated financial support*. Whether financial support is subordinated looks at the substance of the financial support rather than its form. Whether equity is sufficient depends on the facts and circumstances and the authors believe sufficiency should be assessed qualitatively.

Qualitative assessments can take different forms. Best practices indicate that a forecast showing that cash flows from operating activities will be sufficient to cover debt service is an example of a qualitative assessment that equity

is sufficient. Similarly, indications show that determinations that equity is at least equal to the amounts customarily required by lending institutions for similar entities or by industry guidelines, such as surety requirements for contractors, are additional examples.

The Power to Direct Significant Activities. FASB ASC 810-10 (formerly SFAS No. 167) introduced the notion of having the power to direct the activities of a variable interest entity that most significantly impact its economic performance. This notion requires identifying—

a. the goals in forming the entity,

b. the activities that are most important to ensuring that the entity meets those goals, and

c. the party that in substance controls those activities.

The authoritative literature on accounting for a variable interest in a variable interest entity does not define *economic performance*. However, indications show that how an entity's economic performance is viewed depends on the reasons it was formed. The determination of economic performance therefore depends entirely on the facts and circumstances.

Determining Whether the Other Entity is a Variable Interest Entity. Once the reporting entity determines that it has a relationship that requires it to consider the authoritative literature on accounting for a variable interest in a variable interest entity, the next step is to consider whether the entity with which the reporting entity has the relationship is a variable interest entity. Generally, an entity is considered to be a variable interest entity if *either* of the following conditions is met:

a. Its equity is not sufficient to finance the entity's activities without additional subordinated financial support, *or*

b. Its equity investors do not have—

   (1) the power to direct the activities of the entity that most significantly impact its economic performance,

   (2) the obligation to absorb the entity's losses, or

   (3) the right to receive its benefits.

This definition effectively states that, for an entity to *not* be considered a variable interest entity, its equity investors must—

a. have enough equity investment at risk that the entity will be able to stand on its own,

b. have the power to direct the activities of the entity that most significantly impact its economic performance,

c. bear the risk of the entity's losses, *and*

d. have the right to receive the entity's benefits.

The determination of whether the entity is a variable interest entity is only relevant to determining whether the *reporting entity* should include the consolidated financial results of the entity in its financial statements, *even if* the reporting entity does not hold a majority voting equity interest in the entity. As a practical matter, however, even if the reporting entity has a relationship with an entity considered to be a variable interest entity, the reporting entity may not be required to include in its financial statements the consolidated financial results of the entity.

The remaining considerations required by the authoritative literature on accounting for a variable interest in a variable interest entity may lead to the conclusion that the *reporting entity* does *not* have a controlling financial interest.

Determining Whether the Reporting Entity Has a Variable Interest in a Variable Interest Entity. If the reporting entity determines that the entity with which it has one of the prescribed relationships in paragraph is a variable interest entity, it must determine whether it has a variable interest in that entity. The determination that the entity is a variable interest entity establishes the presumption that if there is a controlling financial interest in the entity, it will be established through a *variable interest*.

A *variable interest* in a variable interest entity is a contractual, ownership, or other pecuniary interest in the entity that changes with fluctuations in the fair value of the entity's net assets. Whether a financial instrument is considered to be a variable interest is only relevant to the variable interest entity considerations, not for consideration of other GAAP requirements.

Conceptually, a pecuniary interest is a variable interest only if it will absorb losses of the variable interest entity. Therefore, assets of a variable interest entity generally are not considered variable interests, and liabilities and equity of the entity are considered variable interests. Certain arrangements, such as guarantees, may also be considered variable interests. However, although an equity interest in a variable interest entity always gives its holder a variable interest, whether a liability of the entity gives the creditor a variable interest depends on the facts and circumstances.

If the reporting entity has a majority voting equity interest in an entity, it may be required to consider both the general consolidation requirements and the requirements on accounting for a variable interest in a variable interest entity. Holding an equity interest in an entity the reporting entity formed is one of the relationships that requires the reporting entity to consider the guidance on accounting for a variable interest in a variable interest entity. Holding an equity interest also gives the reporting entity a variable interest in the other entity. The reporting entity must therefore determine whether the entity is a variable interest entity. Whether a majority voting equity interest in an entity that is not a variable interest entity gives its holder a controlling financial interest requires judgment.

Determining Whether Consolidation is Required. If the reporting entity determines that it has a variable interest in a variable interest entity, it must then determine whether it is required to include the consolidated financial results of the entity in its financial statements. The party that has a controlling financial interest in a variable interest entity is considered to be its *primary beneficiary*; however—

a. An individual may be the primary beneficiary.

b. Not all variable interest entities have a primary beneficiary, just as not all entities that are not variable interest entities have a controlling financial interest. For example, all of the equity investment in an entity that is not a variable interest entity may be held by two individuals who have equal voting interests. Similarly, two holders of variable interests in a variable interest entity may share the obligation for the losses of the entity and the right to its benefits.

To be considered the primary beneficiary of a variable interest entity, an individual or entity must have a variable interest in the variable interest entity and have *both* of the following characteristics:

a. The power to direct the activities of the variable interest entity that most significantly impact the economic performance of the variable interest entity, *and*

b. *Either* the obligation to absorb losses of the variable interest entity that could potentially be significant *to the variable interest entity* or the right to receive benefits from the variable interest entity that could potentially be significant *to the variable interest entity*.

The determination of whether the reporting entity is the primary beneficiary of the variable interest entity may require the reporting entity to consider related-party relationships as well. The reporting entity should first determine whether it has both of the characteristics of a primary beneficiary. If it has both characteristics, the reporting entity should include the consolidated financial results of the variable interest entity in its financial statements.

If the reporting entity lacks one or both characteristics, it should determine whether one of its related parties has both characteristics. If a related party has both characteristics of a primary beneficiary, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

If a related party does not have both characteristics of a primary beneficiary, the reporting entity should determine whether the reporting entity and its related parties as a group have both characteristics of a primary beneficiary. If the group does not have both of those characteristics, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

However, if the group has both characteristics, the reporting entity should determine whether it is the member of the group most closely associated with the variable interest entity. If the reporting entity is the most closely associated party, it should include the consolidated financial results of the variable interest entity in its financial statements. If it is not the most closely associated party, the reporting entity should not include the consolidated financial results of the variable interest entity in its financial statements.

The determination of whether the reporting entity is the party in the related-party group most closely associated with the variable interest entity should be made based on assessments of all relevant facts and circumstances, including—

a. whether there is a principal-agency relationship between members of the related-party group,

b. the relationship and significance of the activities of the variable interest entity to members of the related-party group,

c. the exposure of members to the variability associated with the anticipated economic performance of the variable interest entity, and

d. the design of the variable interest entity.

Rather than viewing the assessments as a scorecard, the results of the four assessments should be evaluated together. Depending on the facts and circumstances, one of the assessments may be viewed as providing more persuasive evidence of which party is most closely associated than the other assessments.

Disclosures. Certain disclosures when consolidation is required.

Effects of Applying This Guidance. Contractors should determine whether FASB ASC 810-10 [formerly FIN 46(R)] will require consolidation and, if so, determine whether consolidation will cause negative affects to banking relationships, such as creating violations of loan covenants. Because the consolidation of certain entities may greatly affect the contractor's financial picture, bonding relationships may also be negatively impacted. Contractors and their accountants should also determine whether additional information will be needed for the consolidation because entities that will require consolidating may not have prepared financial statements using generally accepted accounting principles in the past.

Construction Joint Ventures. A construction joint venture is a type of relationship that contractors are commonly involved in that often meet the qualifications of a VIE. Contractors frequently participate in construction joint ventures with other parties to share risks, combine financial and other resources, or obtain financing or bonding. A construction joint venture may be project specific or it may be a permanent arrangement. The legal form of these entities varies and can be C corporations, general partnerships, unincorporated joint ventures, limited partnerships, limited liability companies, and S corporations.

Other entities that often qualify as a VIE in the construction industry include:

- Highly leveraged entities.
- Land owner entities.
- Investment partnerships.
- Real estate partnerships and joint ventures.

Applicability to Income Tax Basis Financial Statements. As previously mentioned, some contractors have chosen to issue financial statements prepared on the income tax basis of accounting as an alternative to consolida-

tion in accordance with GAAP for VIEs. An AICPA Technical Practice Aid (TIS 1500.06) addresses the application of GAAP for VIEs to income tax basis financial statements. According to the TPA, those consolidation requirements do not apply to financial statements prepared using the income tax basis of accounting since consolidation for tax-basis financial statements is based on the Internal Revenue Code. However, an entity that issues financial statements prepared in conformity with the income tax basis of accounting may be required to make certain disclosures required by GAAP for VIEs.

The TPA refers to the guidance on evaluating the adequacy of disclosure in financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles found in Interpretation 14 (AU 9623.90–.95) of SAS No. 62. In evaluating the need for those disclosures, Interpretation 14 requires consideration of the need for that same disclosure, or for a disclosure that communicates the substance of those requirements, based on the relevance of the information to the basis of accounting. Either the disclosure that would be required by FIN 46(R)(FASB ASC 810-10) or the disclosure that communicates the substance of those requirements would likely be relevant to financial statements prepared on the basis of accounting used for income tax reporting, even if the cash method is used for income tax reporting. The TPA states examples of matters that might require disclosure are related-party transactions, guarantees, and commitments.

Equity Method

Generally, the holder of a voting equity interest in an entity that does not give it a controlling financial interest, but gives it the ability to exercise significant influence over the operating and financial policies of the entity, should use the equity method to account for the investment. The equity method is commonly used by many contractors to account for their investments in construction ventures. The ability to exercise significant influence is sometimes difficult to measure. However, if a contractor owns 20% or more of a venture, the contractor is generally presumed to exert significant influence unless there is *predominant evidence to the contrary*.

Holding 20% or more of a venture does not create an absolute requirement to use the equity method for the investment. The 20% ownership level is usually a reasonable presumption for significant influence over a public company. However, for a nonpublic company, ownership of considerably more than 20% may be necessary, as a practical matter, to exercise significant influence. The following are two examples suggested in FASB ASC 323-10-15-10 and 15-11 (formerly Paragraph 4 of FASB Interpretation No. 35) as possible indicators of lack of significant influence that is not unusual for nonpublic companies:

a. Majority ownership of the investee is concentrated among a small group of shareholders who operate the investee without regard to the views of the investor.

b. The investor needs or wants more financial information to apply the equity method than is available to the investee's other (owners) . . ., tries to obtain that information, and fails.

Situations such as those described above are not conclusive indications of lack of significant influence. All of the attendant facts and circumstances must be evaluated. If the ownership percentage exceeds 50%, the venture should generally be consolidated with the contractor.

APB Opinion No. 18, (FASB ASC 323-10), addresses applying the equity method to investments in voting common stock. EITF Issue No. 02-14, "Whether an Investor Should Apply the Equity Method of Accounting to Investments Other Than Common Stock" (FASB ASC 323-10-15-13 and 15-19) expanded the application of the equity method to investments that are in-substance common stock. An investment may be considered in-substance common stock if it has risk and reward characteristics that are substantially similar to the entity's common stock. An investment is considered to be in-substance common stock if all of the following characteristics are substantially similar to the entity's common stock:

- Subordination features, such as liquidation preferences.

- Risks and rewards of ownership, such as participation in earnings, losses, and appreciation and depreciation in value.

- Obligation to transfer value, such as a mandatory redemption provision.

- Future changes in its fair value is expected to vary directly with changes in the common stock's fair value.

If any of these characteristics are not met, the investment is not considered in-substance common stock and should not be accounted for using the equity method.

Measurement Using the Equity Method. Under the equity method, the investment is initially recorded at cost, following the requirements in FASB ASC 805-50-30 [formerly SFAS No. 141(R)] is increased by the investor's proportionate share of the investee's net income, and is reduced by dividends and the investor's proportionate share of the investee's net loss. However, the investment is not reduced below zero unless the investor is committed to providing financial support to the investee. If there is a difference between the cost of the investment and the investor's proportionate equity in the investee's net assets at acquisition, the difference should first be related to specific assets of the investee based on their fair market value. Any difference that cannot be related to specific assets is considered to be attributable to goodwill. The investor should adjust the investment account and investment earnings by an amount that represents the additional depreciation or amortization related to the difference as if it were actually recorded by the investee. (Unless the difference is material, it usually is accounted for as goodwill, instead of attempting to associate it with specific assets and recording the related depreciation.) The equity method is sometimes referred to as a "one-line consolidation" because stockholders' equity and the investor's net earnings generally should be the same whether the equity method is used or the two companies are consolidated. Thus, the amortization of the difference between cost and proportionate equity in net assets and other transactions and events follows essentially the same GAAP as consolidation, for example, intra-entity profits should be eliminated.

An Example of Equity Calculations. Assume the following facts for ABC Company (an equity investee):

			Net Book Value	
	Earnings	Dividends	100%	40%
Acquisition			$ 75,000	$ 30,000
End of Year:				
1	$ 25,000	$ —	100,000	40,000
2	30,000	10,000	120,000	48,000
3	35,000	15,000	140,000	56,000
4	30,000	5,000	165,000	66,000
5	15,000	—	180,000	72,000

If CAS, Incorporated buys 40% of the stock of ABC at book value, its statements would reflect the following:

	Increase for Earnings	Decrease for Dividends	Investment
Acquisition			$ 30,000
End of Year:			
1	$ 10,000	$ —	40,000
2	12,000	4,000	48,000
3	14,000	6,000	56,000
4	12,000	2,000	66,000
5	6,000	—	72,000

To illustrate the mechanics of applying the equity method, the following entries would be made by CAS for Year 2:

Cash	$ 4,000	
Investment		$ 4,000
To record receipt of dividend.		
Investment	$ 12,000	
Equity in earnings of ABC		$ 12,000
To record earnings on investment.		

Expanded Equity Method. This method can be used whenever the equity method is appropriate. Under this method, the contractor presents its proportionate share of the venture's assets, liabilities, revenues, and expenses in capsule form. The elements commonly presented include the contractor's share of net current assets, current liabilities, noncurrent assets, noncurrent liabilities, revenues, and expenses.

Income Tax Considerations. For income tax reporting, any investment of less than 80% ownership has to be accounted for using the cost method, and income is recognized as dividends are received. Thus, if an investment is carried on the equity basis for financial reporting, there may be a temporary difference between pretax accounting income and taxable income caused by the equity method.

Cost Method

The cost method should be used to account for any investment in a venture over which the contractor cannot exert significant influence. This method is generally appropriate for any investments of less than 20% ownership. Under the cost method, the investment is recorded by the contractor at cost, which generally remains unchanged unless a permanent impairment in value occurs. Earnings of the venture are recognized by the contractor only to the extent of dividends received. Losses are not recorded unless they indicate a permanent decline in value.

Prorata Combination

Investments in unincorporated joint ventures are sometimes structured such that each venturer receives an *undivided interest* in the joint venture's assets and liabilities. In these arrangements, the venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability. Use of the prorata combination method to account for an investment of this type accurately reflects the substance of the ownership structure. Under this method, the investor records his share of the individual assets, liabilities, revenues, and expenses of the joint venture. The following example illustrates the assets, liabilities, revenues, and expenses that would be recorded by a contractor that uses the prorata combination method to account for its 25% interest in a joint venture:

	Venture's Total	Investor's Share
Cash	$ 50,000	$ 12,500
Costs in excess of billings	500,000	125,000
Equipment	800,000	200,000
Payables	(200,000)	(50,000)
Debt	(750,000)	(187,500)
Beginning equity	(300,000)	(75,000)
Current year revenues	(900,000)	(225,000)
Current year expenses	800,000	200,000

In FASB ASC 910-810-45-14 (formerly EITF Issue No. 00-1, "Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures"), contractors are also allowed to use the pro rata combination method for an investment in an *unincorporated legal entity* in the construction industry. However, the equity method must be used if the contractor invests in the common stock of a corporate entity and has significant influence over that entity.

Summary of Accounting Methods for Investments in Ventures

The accounting for investments in ventures is influenced by the extent of control the contractor has over the operations of the venture. Generally, the relationships are as follows:

a. *Less than 20%.* The cost method is normally used for these investments because of the presumption that the contractor will be unable to significantly influence the affairs of the venture. Cost is reduced for permanent declines in value, and dividends are treated as income when received.

b. *More than 50%.* A holding of more than 50% of the voting stock of another company normally constitutes control and requires presentation of consolidated financial statements.

c. *Between 20% and 50%.* There is a *presumption*, according to FASB ASC 323-10-15-8 (formerly APB Opinion No. 18), that a contractor that owns between 20% and 50% of a venture has the ability to exercise significant influence over the venture and should account for the investment using the equity method.

ACCOUNTING FOR SIMILAR OPERATIONS

Construction contractor accounting principles can be applied to some similar business activities, but not to others. The environment and contractual arrangements of some businesses have characteristics similar to those of construction contractors, but the businesses do not operate directly in the construction industry. Common examples for which construction contractor accounting principles apply are as follows:

a. Architects.

b. Engineers.

c. Construction managers that enter into an agency contract with an owner to supervise and coordinate the construction activity on a project, including the negotiation of contracts with others for all construction work.

d. Companies that design, develop, manufacture, or modify complex equipment to a buyer's specifications.

This section addresses two common examples of similar operations for which the contractor accounting principles may be appropriate:

a. Homebuilders.

b. Certain manufacturing activities.

Accounting by Homebuilders

Homebuilders have many of the characteristics of construction contractors. However, they differ from construction contractors in that they often build on their own land. Their operations typically consist of the following activities:

a. Building homes under a contract with the customer:

   (1) on lots owned by the customer, or

   (2) on lots owned by the homebuilder; and

b. Building on a speculative basis, that is, without a sales contract.

Homebuilders often buy developed lots in several housing developments. Customers have the option of selecting one of those lots or furnishing their own lot. Similarly, the homebuilder usually has several basic plans, and customers have the option of selecting from those plans, either unmodified or modified, or supplying their own.

Homebuilders may have land and lot option purchase contracts with entities that could be considered variable interest entities. Typically, the homebuilder makes a deposit (often nonrefundable) with entities for the option to purchase land at a future date at a fixed price from an entity that is often structured as a limited liability company. If a deposit's refund is conditional, then the entity is probably a variable interest entity, and the homebuilder will need to determine if it is the primary beneficiary and is, thus, required to consolidate the entity. However, FASB ASC 810-10-25-55 and 25-56 [formerly FIN 46(R)] excludes an interest in a specific asset when the asset's fair value is less than half of the entity's assets (and that interest is the homebuilder's only interest in the entity). For example, a homebuilder holds an interest in an entity that owns Land A with a fair value of $20,000 and no other interest in the entity, and the entity's total fair value of assets is $80,000.

The mix of speculative and contract building changes from year to year depending on economic conditions. In addition, some houses are started on a speculative basis and placed under contract during construction. That

happens at varying stages of construction—some are early enough in the construction period so the buyer can modify the plans, but some are close to closing.

If the homebuilder owns the lot, title typically does not pass until closing. In addition, down payment requirements often vary such as indicated below:

a. If a homebuilder uses a basic unmodified plan, a small down payment may be required because the homebuilder has little to lose if the house converts to speculative if the buyer defaults.

b. If the homebuilder's architectural plans are modified or the buyer supplies custom plans, a larger down payment often is required to lock in the buyer.

Houses are often built under contracts that contain contingencies such as obtaining suitable financing or selling a present home. Under those arrangements, the homebuilder will often include a clause requiring the contingency to be cured prior to the midpoint of construction so that, if not cured, the house may be converted to speculative.

Income Recognition. How income is recognized depends on whether the home is built on a lot owned by the homebuilder or on the buyer's lot, as summarized below:

a. If the homebuilder builds on the buyer's lot under contract, the authors believe that the homebuilder is functioning as a construction contractor and construction revenue recognition guidance, as previously discussed in this chapter, would govern accounting for the contract. (Building on the buyer's lot without a contract would be rare for homebuilders.)

b. If the home is built on a lot owned by the homebuilder, the authoritative literature governing real estate applies both to building under contract and to speculative building.

It is clear that speculative building is not covered by the authoritative literature related to construction contractors since there is no contract. However, some have questioned whether contract building on homebuilders' lots is covered by the construction contractor literature or whether, since the contract involves the sale of a lot in addition to constructing the home, the transactions are covered by the real estate literature.

FASB ASC 605-35 (formerly SOP 81-1) basically excludes construction contracts for which authoritative accounting literature provides special methods of accounting. FASB ASC 970-360-55 (formerly EITF Issue No. 86-7, "Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts") concluded that the real estate literature of FASB ASC 360-20 and 970 (formerly SFAS Nos. 66 and 67, respectively) applied. (Note that the construction contractor accounting literature still would apply to contract building on a lot already owned by the buyer.)

FASB ASC 360-30; 970-605 (formerly SFAS No. 66) provides guidance on income recognition, and FASB ASC 970-10;970-340; 970-360;970-605; 970-720-25 (formerly SFAS No. 67) provides guidance on accounting for costs. Best practices indicate that these accounting requirements normally produce the same results concerning cost accumulation as described for construction contractors in section . Unless a sale has been consummated, recognizing income under the deposit method, which defers all revenues and costs until closing, is required. FASB ASC 360-20-40-7 (formerly Paragraph 6 of SFAS No. 66) states all of the following conditions must be met before a sale is considered to be consummated:

a. The parties are bound by the terms of a contract;

b. All consideration has been exchanged;

c. Any permanent financing for which the seller is responsible has been arranged; *and*

d. All conditions precedent to closing have been performed.

It has been found that homebuilders constructing on their own lots normally will not meet the preceding tests until closing because consideration has not been exchanged, and all conditions precedent to closing have not been performed. Accordingly, the deposit method generally would be used.

Although the deposit method is similar to the completed-contract method in many respects, it differs as follows:

Deposit Method	Completed-contract Method
1. Progress billings are recorded as a liability.	1. Progress billings are offset against contracts in progress.
2. Profit is recognized at closing.	2. Profit is recognized upon substantial completion.

The financial statements should refer to the deposit method, rather than the completed-contract method, in describing policies to account for the transactions.

If a homebuilder has some projects under contract for construction on the buyers' lots and others for construction on lots owned by the homebuilder, the percentage-of-completion or the completed-contract method would apply to the contracts using the buyers' lots, and the deposit method would apply to contracts using the homebuilder's lots and to speculative building. In that situation, separate policy notes might be provided for revenue and cost recognition.

Because homebuilders normally finance the construction of homes under lines of credit that must be repaid as the homes are sold, they rarely offer long-term mortgage financing to home buyers. However, if a homebuilder finances all or part of a sale involving a lot owned by the homebuilder, the accountant must consider whether the gross profit on the sale should be recognized in the year of sale or as the mortgage loan is collected. Real estate authoritative guidance prescribes tests to determine the profit recognition and resolves the issue based primarily on down payment and continuing investment requirements that must be met. If the requirements for use of the "full accrual" profit recognition method are met, then all profit on a sale financed by the homebuilder can be recognized upon the closing of the sale.

Construction Financing. Homebuilders often finance construction costs through construction loans payable to financial institutions. The loans are similar to equipment floor plans, and, as houses are sold, the related construction loans must be paid off. In many cases, substantially all of the construction costs are financed through such loans.

In many cases, the homebuilder's internal accounting policy for recording interest may produce results that are materially close to the GAAP requirements. Since interest is a significant cost to many homebuilders, the authors have found that they generally charge interest on a project to construction costs using monthly statements provided by the financing institution. If construction loans have been obtained on individual projects, interest can be charged directly to the project. However, if a loan covers more than one project, the monthly interest statement would show interest for the loan rather than for the individual projects. Homebuilders often allocate the interest on those statements to individual lots based on their internal records of draws against those lots.

Typically, the homebuilder finances substantially all costs of the project through construction loans, and the results of the method described above usually would be materially close to GAAP requirements. However, adjustments are sometimes needed for speculative houses that sit for long periods awaiting a buyer. In those circumstances, it has been found that many homebuilders continue charging interest costs to the project until it is sold. Interest between substantial completion and sale should be expensed, and adjustment would be needed to the homebuilder's records for those houses.

Points, Commitment Fees, and Closing Costs. Homebuilders sometimes pay points to financial institutions to obtain more favorable mortgage rates for the buyer. For example, a mortgage banker will accept a lower interest rate (and therefore lower future monthly payments) in exchange for a payment today. That payment, which is often referred to as a *buy-down point*, is an inducement for someone to buy when interest rates would otherwise make monthly payments so high that they would preclude the sale. Buy-down points usually are listed on the closing statement and should be charged to cost of sales.

Other closing costs incurred by the homebuilder that are shown on the closing statement (such as loan origination fees, other points paid by the homebuilder, and real estate taxes) also should be charged to cost of sales.

Homebuilders sometimes pay a fee to a financing institution to ensure the availability of construction financing. If the fee is material, amortizing the fees, based on FASB ASC 835-30) (formerly APBO, within 21, *Interest on Receivables and Payables*) using the following guidance:

a. If the loan is payable on demand, the fees should be amortized using the straight-line method over a period consistent with the understanding between the borrower and lender. If no such understanding exists, the fees should be amortized over the borrower's estimate of the period that the loan will be outstanding. Any unamortized amount should be charged to interest expense when the loan is paid in full.

b. If the loan is a revolving line of credit or similar arrangement with no scheduled payments, the fees should be amortized using the straight-line method over the period the line is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. Any unamortized amount should be charged to interest expense when the line is paid.

c. If a loan commitment expires unexercised, the fees should be charged to interest expense in the period of expiration.

d. Fees for all other arrangements should be charged to interest expense using the interest method. If the loan's stated interest rate varies based on future changes in an independent factor (for example, prime plus 1%), the calculation of the constant effective yield should be based either on the factor that is in effect at the inception of the loan or on the factor as it changes over the life of the loan.

Financial Statements. The financial statements of homebuilders are similar to those of construction contractors.

Applying Construction Contractor Accounting to Manufacturing Operations

Some manufacturing activities are similar to construction contracting and the same accounting rules should be applied. Instead of addressing the types of manufacturing operations that would be accounted for using construction contractor principles, FASB ASC 605-35-15-6 (formerly Paragraph 14 of SOP 81-1) describes the types of manufacturing operations that *would not be subject* to those principles:

> Sales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels, if such sales are normally recognized as revenue in accordance with the realization principles for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

In other words, if a manufacturing operation meets all of the following criteria, construction contractor accounting principles *cannot* be applied to it, and *no profit* may be recognized prior to completion:

a. The product is produced in a standard manufacturing operation;

b. The product is sold in the ordinary course of business through regular marketing channels;

c. Sales are normally recognized as revenue when realized; and

d. Costs are accounted for in a manner similar to other inventory costs.

Best practices indicate that the preceding criteria narrow the manufacturing operations to which construction contractor accounting may be applied.

For example, a manufacturer of custom saddles and bridles would probably only manufacture for specific customer orders, but the manufacturing process and the marketing for all saddles and bridles would probably be similar. As a result, GAAP would preclude contractor accounting, and all revenues would probably be recognized on shipment. A large order from a wholesaler might require delivery of all of the order at once and, if so, no revenue would be recognized prior to completion of the order. However, if the order permitted partial shipments, revenue would be recognized as those shipments are made.

The following are other examples of manufacturing operations for which construction contractor accounting probably would not be appropriate; instead, revenue probably would be recognized on completion:

a. A company manufactures boats under customer contracts in which it offers six basic designs and provides customers with several options for modifications.

b. A manufacturer of pallets receives a fixed-price contract to supply a trucking company with pallets.

c. A machine shop tools specialty parts under contracts with manufacturers.

It is believed that construction accounting principles *should* be applied to manufacturing activities that meet all of the following criteria:

a. *Business Environment.* FASB ASC 910-10-15-4 lists the following characteristics of a construction contractor's business environment, which should be present in order for a manufacturer to use the construction contractor accounting principles:

   (1) A contractor normally obtains its contracts by bidding or negotiating for specific projects.

   (2) A contractor bids or negotiates the initial contract price based on an estimate of the cost to complete the contract and the desired profit margin, although the initial price may be changed or renegotiated.

   (3) A contractor may be exposed to significant economic risks in the performance of a contract, particularly when the price is fixed.

   (4) Owners frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance requirements.

   (5) A contractor typically accumulates and accounts for costs and revenues by individual contracts or contract commitments extending beyond one accounting period.

b. *Contractual Arrangements.* A legally enforceable contract should exist which specifies the work to be performed, the basis of determining the amount, and terms of payment of the contract price. Generally, the contract must require total performance before the contractor's obligation is discharged.

c. *Product Characteristics.* The product must differ significantly from goods produced in the company's other manufacturing operations.

The following are examples of manufacturing operations for which construction contractor accounting would probably be appropriate:

a. A manufacturer of boat trailers receives a fixed-price contract with the U.S. Army to produce specially designed trailers to transport ammunition.

b. A manufacturer of standard tobacco processing machinery obtains a contract to design and build a special processing system for a new tobacco plant.

COMMON PROBLEMS IN APPLYING CONTRACT ACCOUNTING RULES

As the preceding discussions point out, it is generally more difficult to account for the operations of a construction contractor than for companies in most other industries. Because the GAAP accounting rules are complex and difficult to apply, the accountant must be constantly aware of the many traps or errors that are common to contract accounting. Some common problems associated with construction accounting are summarized in Exhibit 2-3.

Exhibit 2-3

Common Accounting Issues Associated with Contract Accounting

Issue	Type of Error	Correct Accounting
Accumulation of Contract Costs	The cash method is used to accumulate costs, and there may be significant unrecorded liabilities that affect cost records for contracts in progress.	Accrual accounting should be used to recognize all contract costs, and those costs must be allocated to the appropriate individual contract cost records.
	Costs recognized in the disbursement or voucher register are not properly allocated to individual contract cost records.	Contract costs must be recognized both in total in the general ledger accounts and individually for each profit center. The profit center is normally each individual contract. Amounts posted to general ledger control accounts (normally, expense accounts by major category, or in some cases a construction-in-progress account) should agree in total to amounts posted to subsidiary ledgers (the individual contract cost records).
	Certain categories of direct costs are not properly allocated to individual contract cost records.	All direct costs associated with the construction activity should be allocated to individual contract cost records.
	Indirect overhead costs are incorrectly allocated to contract costs.	All indirect costs associated with a construction contract should be allocated to individual contract cost records.
	Production period interest may need to be capitalized, but is not.	Both GAAP and tax rules require the capitalization of construction period interest. GAAP requires the capitalization of production period interest to the extent that cash receipts on a contract do not exceed production costs.
Revenue Recognition	Incorrect selection of the completed-contract method.	In most situations, the percentage-of-completion method should be used.
	Failure to exclude uninstalled material when performing a cost-to-cost percentage of completion evaluation.	In general, uninstalled materials charged to a contract (unless they were specifically fabricated for the contract) should be excluded from actual costs before computing cost-to-cost percentage of completion.

Issue	Type of Error	Correct Accounting
	Total estimated contract cost may not reflect adequate overhead costs, additional costs due to problems encountered on the contract, increased costs due to inflation, etc.	Total estimated cost of a contract must be adjusted to reflect management's best estimates of the actual cost to complete the contract. This adjustment must be made before a cost-to-cost percentage of completion calculation can be made.
Loss Contracts	Failure to accrue for loss contracts.	When the estimated total cost of a contract is projected to exceed the corresponding contract price, a loss accrual is required, regardless of which accounting method is used.
Unused Materials	Incorrectly transferring unused materials back to the warehouse or to the next job at cost, even if it exceeds market; or expensing the cost of unused materials to the completed job and therefore carrying the inventory at a zero cost.	Unused materials at the completion of a job should be transferred back to inventory or to the next job at the lower of cost or net realizable value.
Retentions	Failure to record retentions since they represent receivables that will not be collected until a project is complete.	Retentions should be recorded as billed. In addition, they should be reported separately in the accounting records from progress bills currently due so that agings will be correct.
Investments in Joint Ventures, Partnerships, or Other Entities	Using the cost method to account for such investments regardless of the appropriate method.	Investments which can be controlled by the contractor should generally be consolidated. Investments over which the contractor can exert significant influence should normally be accounted for using the equity method. The cost method is appropriate for all other investments.
Deferred Taxes	Failure to identify temporary differences between book and taxable income.	Tax law and GAAP rules for contractors may vary significantly, and deferred tax accounting is necessary for all temporary differences between book and taxable income.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

35. Which of the following statements regarding consolidation of a partnership is accurate?

    a. A contractor who owns more than 50% of a partnership always has the power of controlling interest.

    b. A contractor that owns less than 50% of the voting interest, does not have the power to control a partnership.

    c. A noncontrolling investor in a partnership that own more than 50% of the partnership should not use the consolidation method.

    d. The financial statements of the contractor and the partnership should never be consolidated if a contractor's ownership percentage is 50% or less.

36. Once a reporting entity determines that is has a variable interest in a variable interest entity, it must decide if it is required to include the consolidated financial results of the entity in its financial statements. The party that has the controlling financial interest in a variable interest entity (VIE) is considered the primary beneficiary. Which of the following statements regarding the primary beneficiary is most accurate?

    a. Authoritative literature states that individuals may not be the primary beneficiary.

    b. The entity must have variable interest in the VIE to be considered a primary beneficiary.

    c. All VIEs must have a primary beneficiary.

37. According to FASB ASC 810-10-45-16 (formerly SFAS No. 160), noncontrolling interest should be presented in the consolidated balance sheet equity section using which of the following methods?

    a. Noncontrolling interest should be included as part of the parent's equity.

    b. Noncontrolling interest should be presented separately from the parent's equity.

38. In which of the following circumstances should the equity method be used?

    a. When the contractor is presenting its proportionate share of the venture's assets, liabilities, revenues, and expenses in capsule form.

    b. To account for any investment in a venture that the contractor cannot exert significant influence over.

    c. To account for any investment if the contractor can exercise significant influence over the investee's operations.

39. The extent of control the contractor exercises over the operations of the venture influences the accounting method the contractor uses to account for investments in ventures. If the contractor exercises between 20% and 50% control over the operations of the venture, the contractor should account for the investment by which of the following?

    a. Using the cost method.

    b. Using the equity method.

    c. Presenting consolidated financial statements.

40. Under the *deposit method*, when is profit recognized?

    a. Upon substantial completion.

    b. At closing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

35. Which of the following statements regarding consolidation of a partnership is accurate? **(Page 89)**

    a. A contractor who owns more than 50% of a partnership always has the power of controlling interest. [This answer is incorrect. A contractor who owns more than 50% of a partnership may not possess control if major decisions must be approved by one or more of the other partners. Thus, the contractor will not consolidate.]

    b. A contractor that owns less than 50% of the voting interest, does not have the power to control a partnership. [This answer is incorrect. A contractor may still have the power to control a partnership even if they own less than 50% of the voting interest in cases where voting interest is not clearly indicated and the contractor owns a majority interest in profits or losses.]

    c. A noncontrolling investor in a partnership that own more than 50% of the partnership should not use the consolidation method. [This answer is correct. A noncontrolling investor in a partnership should not use the consolidation method even if the investor owns a majority of the partnership. An investor in a limited partnership generally is less likely to have a controlling interest or to exert significant influence than an investor in a general partnership.]

    d. The financial statements of the contractor and the partnership should never be consolidated if a contractor's ownership percentage is 50% or less. [This answer is incorrect. If a contractor can exercise control by means such as contract, lease agreement with other partners, or by court decree, the financial statements of the contractor and the partnership should be consolidated, even in cases where ownership percentage is 50% or less.]

36. Once a reporting entity determines that is has a variable interest in a variable interest entity, it must decide if it is required to include the consolidated financial results of the entity in its financial statements. The party that has the controlling financial interest in a variable interest entity (VIE) is considered the primary beneficiary. Which of the following statements regarding the primary beneficiary is most accurate? **(Page 93)**

    a. Authoritative literature states that individuals may not be the primary beneficiary. [This answer is incorrect. An individual may be the primary beneficiary in a VIE according to authoritative literature.]

    b. The entity must have variable interest in the VIE to be considered a primary beneficiary. [This answer is correct. To be considered the primary beneficiary of a VIE, the entity must have a variable interest in the VIE and have the power to direct the activities of the VIE that most significantly impact the economic performance of the VIE, and have either the obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.]

    c. All VIEs must have a primary beneficiary. [This answer is incorrect. Not all VIEs have a primary beneficiary, just as not all entities that are not VIEs have a controlling financial interest. Two holders of variable interests in a variable interest entity may share the obligation for the losses of the entity and the rights to its benefits.]

37. According to FASB ASC 810-10-45-16 (formerly SFAS No. 160), noncontrolling interest should be presented in the consolidated balance sheet equity section using which of the following methods? **(Page 89)**

    a. Noncontrolling interest should be included as part of the parent's equity. [This answer is incorrect. FASB ASC 810-10-45-16 (formerly SFAS No. 160) requires that noncontrolling interest should be presented, but not included with the parent's equity amount.]

    b. Noncontrolling interest should be presented separately from the parent's equity. [This answer is correct. Noncontrolling interest should be presented, but be presented separately from the parent's equity in accordance with the requirements of FASB ASC 810-10-45-16 (formerly SFAS No. 160.]

38. In which of the following circumstances should the equity method be used? **(Page 95)**

    a. When the contractor is presenting its proportionate share of the venture's assets, liabilities, revenues, and expenses in capsule form. [This answer is incorrect. The e*xpanded equity method* should be used when the contractor is presenting its proportionate share of the venture's assets, liabilities, revenues, and expenses in capsule form.]

    b. To account for any investment in a venture that the contractor cannot exert significant influence over. [This answer is incorrect. The *cost method* should be used to account for any investment in a venture over which the contractor cannot exert significant influence.]

    c. To account for any investment if the contractor can exercise significant influence over the investee's operations. [This answer is correct. The equity method should be used to account for any investment if the contractor has the ability to exercise significant influence (owns 20% or more of a venture) over the investee's operations.]

39. The extent of control the contractor exercises over the operations of the venture influences the accounting method the contractor uses to account for investments in ventures. If the contractor exercises between 20% and 50% control over the operations of the venture, the contractor should account for the investment by which of the following? **(Page 97)**

    a. Using the cost method. [This answer is incorrect. The cost method is normally used if the contractor exercises less than 20% control over the operations of the venture due to the presumption that the contractor will be unable to significantly influence the affairs of the venture.]

    b. Using the equity method. [This answer is correct. FASB ASC 323-10-15- 8 (formerly APB Opinion No. 18) presumes that a contractor that owns between 20% and 50% of a venture has the ability to exercise significant influence over the venture and, therefore, should account for the investment using the equity method.]

    c. Presenting consolidated financial statements. [This answer is incorrect. Presenting consolidated financial statements is normally used if the contractor holds more than 50% of the voting stock of another company since this normally constitutes control.]

40. Under the *deposit method*, when is profit recognized? **(Page 100)**

    a. Upon substantial completion. [This answer is incorrect. Profit is recognized upon substantial completion under the *completed-contract method*.]

    b. At closing. [This answer is correct. Per GAAP, profit is recognized at closing under the deposit method.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (CONTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

19. If a construction contractor typically builds under contracts lasting 18 to 24 months and the vast majority of the contracts have 6 to 9 months remaining to completion at year end, the normal operating cycle is which of the following?

    a. 6 to 9 months.

    b. 18 to 24 months.

    c. 18 to 30 months.

    d. 18 to 33 months.

20. For construction contractors, which of the following is a contract-related *asset* for the purpose of classifying those assets based on the operating cycle concept?

    a. Deferred taxes that result from temporary differences in expense recognition methods and contract revenue.

    b. Advanced payments on contracts for the purposes of mobilization or other purposes.

    c. Obligations for equipment purchased expressly for an individual contract without regard for the payment terms of the obligations.

    d. Small tools and equipment that were specifically purchased to be used on a particular individual contract.

21. Which of the following is a financial instrument and subject to the FASB ASC 815 (formerly SFAS No. 133) disclosure requirements?

    a. Construction contracts.

    b. Weather derivatives.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

22. FASB ASC 820-10 (formerly SFAS No. 157, *Fair Value Measurements*), accomplishes all of the following **except**:

    a. Increases the use of fair value measurements.

    b. Offers a definition of fair value that is common.

    c. Institutes a framework for measuring fair value within GAAP guidelines.

    d. Increases the disclosures concerning fair value measurements.

23. Amounts that are withheld from payment on in-process contracts until the contracts are successfully completed are considered which of the following?

    a. Trade receivables.

    b. Retention receivables.

    c. Contract receivables.

    d. Do not select this answer choice.

24. Contractors may **not** guarantee the debt of which of the following entities?

    a. Real estate venture

    b. Subcontractor.

    c. Joint venture under its control.

    d. Equipment company.

25. FASB ASC 410-30 (formerly EITF Issue No. 90-8) provides which of the following related to accounting for environmental cleanup costs and liabilities?

    a. Guidance on assessing whether the cost of asbestos removal from buildings should be capitalized.

    b. Guidance as to whether environmental cleanup costs should be capitalized.

    c. Guidance on whether future cash flows for environmental exit costs (long-lived assets) should be included in undiscounted expected future cash flows used to test property for recoverability.

    d. Do not select this answer choice.

26. FASB ASC 410-30 (formerly SOP 96-1) indicates that environmental remediation liabilities should do all of the following **except**:

    a. Be accrued for each specific site when FASB ASC 450-20-25-2 (formerly SFAS No. 5) criteria are met (determined using SOP benchmarks).

    b. Be estimated using anticipated improvements in remediation productivity and technology.

    c. Be estimated based on both pending and enacted laws and regulations.

    d. For employees that spend significant time on remediation activities, include incremental direct costs and compensation and benefit costs.

27. FASB ASC 450-20-30-1 (formerly FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*), allows companies to identify a *range* of estimated losses and record the amount in that range that is the best estimate. If no amount in the range is a better estimate than any other amount, FASB Interpretation No. 14 requires using which of the following?

    a. The lowest amount in the range.

    b. The highest amount in the range.

    c. The middle amount in the range.

    d. Do not select this answer choice.

28. Granite Construction Company wishes to discount an environmental remediation liability to demonstrate the time value of money. Under which of the following circumstances is discounting inappropriate?

    a. The company's share of the aggregate liability amount (or component thereof) is fixed.

    b. The timing and amount of cash payments for the liability (or component) is reliably determinable.

    c. Only a range of possible loss from an environmental liability can be estimated.

    d. Do not select this answer choice.

29. Which of the following statements concerning FASB ASC 360-10 (formerly SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets*), is accurate?

    a. In cases where a long-lived asset that is part of a group of assets that include other assets and liabilities not covered by FASB ASC 360-10 (formerly SFAS No. 144) SFAS No. 144 does not apply to that group of assets.

    b. An asset group under FASB ASC 360-10 (formerly SFAS No. 144) is the highest level that identifiable cash flows are significantly independent of the cash flows of other groups of assets and liabilities.

    c. FASB ASC 360-10 (formerly SFAS No. 144) provides different accounting requirements for a long-lived asset to be disposed of by sale than for a long-live asset disposed of other than by sale.

    d. FASB ASC 360-10 (formerly SFAS No. 144) requires disclosure of long-lived assets held for sale, unless they are impaired.

30. How should a loss be allocated when groups of assets are tested for recoverability and an impairment loss is indicated for the group?

    a. To the individual long-lived assets.

    b. To the minority interest.

    c. To the individual cost records.

    d. To long-term contracts.

31. Construction companies must evaluate whether to report any related gain or loss as a separate component of on-going operations or as a discontinued segment. How should the related gain or loss be accounted for if the activity represents a separate major line of business?

    a. Change in estimate.

    b. Goodwill.

    c. Separate component of income.

    d. Discontinued segment.

32. An indication that it is at least reasonably possible that a change will occur in the near term due to one or more future confirming events and the change would have a material effect on the financial statements should be disclosed for which of the following?

    a. Nature of operations.

    b. Use of estimates.

    c. Certain significant estimates.

    d. Concentrations.

33. Construction companies can be subject to increased risks solely due to the lack of diversification. In this instance, diversification is referred to as which of the following?

    a. Concentration.

    b. Expected losses.

    c. Equipment variance.

    d. Hypothetical adjustment.

34. Which of the following is involved when determining the percentage-of-completion for incomplete long-term contracts at year end?

    a. Estimation.

    b. Overhead burden.

    c. Options and additions.

    d. Economic judgments.

35. FASB ASC 810 (formerly SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), was issued as an amendment of ARB No. 51. Which of the following is **not** accurate regarding the amendments that SFAS No. 160 made to ARB No. 51?

    a. It is effective for fiscal years beginning on or after December 15, 2008, and early adoption is permitted in certain circumstances.

    b. Separate from the parent's equity, the noncontrolling interest in subsidies should be classified in the equity section.

    c. When the parent retains control of the subsidiary, SFAS No. 160 consistently accounts for any changes in the parent's ownership interest in the subsidiary.

    d. It stipulates that losses exceeding the minority interest's investment should not be allocated to the majority interest, but rather continue to be allocated to the minority interest.

36. What percent of ownership is required by the IRS in order for consolidated tax returns to be filed?

    a. 51%.

    b. Two-thirds.

    c. 75%.

    d. 80%.

37. Which of the following is **not** considered a variable interest?

    a. Equity.

    b. Liabilities.

    c. Assets.

    d. Guarantees.

38. The 20% ownership level for determining use of the equity method is usually a reasonable presumption for exercising significant influence over which of the following?

    a. A public company.

    b. A nonpublic company.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

39. For income tax reporting, investments of less than 80% ownership must justified using which of the following methods?

    a. Percentage-of-completion.

    b. Equity.

    c. Expanded equity.

    d. Cost.

40. How are progress billings treated under the *completed-contract method*?

    a. They are recorded as a liability.

    b. They are offset against contracts in progress.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

GLOSSARY

Accrual basis method: Accounting method whereby income and expense items are recognized as they are earned or incurred, even though they may not yet have been received or actually paid in cash.

Cash basis method: Accounting method used by most individual taxpayers. The cash method recognizes income and deductions when money is received or paid.

Change order: A component of the change management process, whereby changes from the agreed upon scope (limitations) of the project's work require a mutual agreement. Change orders are common to most projects, and very common with large projects. After the original scope (or contract) is formed, complete with the total price to be paid and the specific work to be completed, a client may decide that the original plans do not best represent his definition for the finished project. Accordingly, the client will suggest an alternate approach.

Claim: A request by an insured for indemnification by an insurance company for loss incurred from an insured peril. Completed-contract (CC) method; Accounting method recognizes profits at the end of a contract rather than accruing the profits as the work progresses. However, an anticipated loss from a contract must be recognized as soon as it is apparent.

Comprehensive income: A change in equity (net assets) of a business enterprise during a period due to transactions and other events and circumstances from non-owner sources, including all changes in equity during a period except those resulting from investments by owners and distributions to owners.

Cost method: Method of accounting by a parent company for investments in subsidiary companies. The parent maintains the investment in subsidiary account at its cost, not recognizing periodically its share of subsidiary income or loss. This method of accounting is used when one company owns less than 20% of the outstanding voting common stock of another company. It could be used instead of the equity method if 20%-50% of voting common stock is owned but there is a lack of effective control (significant influence). Under the cost method, the investment portfolio is accounted for under the lower of cost or market value applied on a total portfolio basis separately for current and noncurrent securities.

Cost-plus contract: A contract under which the contractor receives payment for total costs plus a stated percentage or amount of profit. A cost-plus percentage contract gives the contractor no incentive to economize; the contractor would actually be better off by spending more. A cost-plus fixed-fee contract is a more reasonable contract.

Cost-to-cost method: Accounting method whereby costs incurred to date are compared to the estimated total costs to be incurred. The percentage of completion is calculated by dividing the costs incurred to date (the numerator) by the estimated total costs to the incurred for a contract (the denominator).

Current assets: Cash, accounts receivable, inventory, and other assets that are likely to be converted into cash, sold, exchanged, or expensed in the normal course of business, usually within one year.

Equity method: Accounting method used by an investor who owns between 20% and 50% of the voting common stock of a company. It can also be used instead of the cost method when the investor owns less than 20% of the company but has significant influence over the investee. Further, it is employed instead of consolidation, even though more than 50% is owned, when one of the negating factors for consolidation exists.

Indirect costs: Manufacturing costs that cannot be easily seen in the product. Electricity, hazard insurance on the factory building, and real estate taxes are examples of indirect costs.

Intrinsic value method: Accounting method where valuation is determined by applying data inputs to a valuation theory or model. The resulting value is then compared to the prevailing market price.

Joint venture: An agreement by two or more parties to work on a project together.

Overhead: Indirect expenses of running a business not directly associated with a particular item or service sold. Electricity, insurance, and benefits paid to workers are overhead expenses. By applying a factor called the *burden rate,* cost accounting attempts to allocate overhead, where possible, to the cost of goods sold.

Percentage-of-completion (PC) method: Accounting for a major project by including a portion of profit periodically. That portion is based on costs incurred compared with total estimated costs.

Performance bond: A contractor's bond, guaranteeing that the contractor will perform the contract and providing that, in the event of a default, the surety may complete the contract or pay damages up to the bond limit.

Profit center: The segment of a business organization that is responsible for producing profits on its own. For instance, a conglomerate with interests in hotels, food processing, and paper may consider each of these three businesses separate profit centers.

INDEX

A

ACCOUNTING SYSTEMS
- Construction in progress approach . . . 14
- Direct P&L approach . . . 13
- General ledger posting . . . 13
- Subsidiary records . . . 12

C

COMPLETED-CONTRACT METHOD—GAAP
- Capitalization of G&A expenses . . . 42
- Conditions for use . . . 30, 32
- Illustration . . . 29
- Interim reporting . . . 32
- Loss contract . . . 36
- Materiality considerations . . . 32
- Point of substantial completion . . . 42

CONSOLIDATION . . . 89

CONTRACT AGREEMENT
- Additions . . . 35
- Combining . . . 7
- Options . . . 35
- Segmenting . . . 7

CONTRACT CLAUSES
- Change orders . . . 34
- Claims . . . 35

CONTRACT TYPES
- Cost-plus contract . . . 19

COST ACCUMULATION—GAAP
- Direct costs
  - Direct labor . . . 15
  - Direct materials . . . 15
  - Leftover materials . . . 15, 102
  - Other direct costs . . . 17
  - Subcontractor costs . . . 16
- Equipment cost pools . . . 20
- Indirect costs
  - Capitalization of interest . . . 19
  - Components of overhead pool . . . 18
  - General . . . 17
  - Methods of allocating overhead . . . 18
- Other cost considerations
  - Back charge adjustment . . . 21
  - Costs in cost-plus contracts . . . 19
  - Equipment costs . . . 19
  - Precontract costs . . . 21
  - Selling, general, and administrative expenses . . . 20
- Problems in applying GAAP . . . 102

D

DERIVATIVE INVESTMENTS . . . 55
- Embedded derivatives . . . 55
- Weather derivatives . . . 56

E

ENVIRONMENTAL CLEANUP COSTS . . . 59

EQUIPMENT COST POOLS . . . 20

EQUITY METHOD . . . 95

F

FAIR VALUE . . . 56
- Common FV areas for contractors . . . 57
- Pending developments . . . 57

FASB CODIFICATION . . . 3

FIELD REPORTS . . . 8

FINANCIAL GUARANTEES . . . 58

FINANCIAL STATEMENTS
- Changes in estimates . . . 74
- Classified balance sheet . . . 53
- Comprehensive income . . . 74
- Disclosures . . . 55, 67, 69
- Discontinued operations and costs to exit an activity . . . 69
- Fair value accounting considerations . . . 56
- Offsetting and netting amounts . . . 54
- S corporation disclosures . . . 67
- Supplementary information . . . 55

G

GAAP, GENERAL . . . 3

H

HOMEBUILDERS
- GAAP accounting rules . . . 98

I

IMPAIRMENT OF LONG-LIVED ASSETS . . . 65

INVESTMENTS IN VENTURES
- Consolidation method
  - GAAP, general guidance . . . 89
  - Tax . . . 90
- Cost method . . . 97
- Equity method
  - Expanded equity method . . . 97
  - GAAP example . . . 96
  - GAAP rules . . . 95
  - Tax . . . 97
- Problems in applying GAAP . . . 102
- Pro rata combination . . . 97
- Summary of GAAP rules . . . 97
- Variable interest entity . . . 90
  - Applicability to income tax basis F/S . . . 94
  - Construction joint ventures . . . 94
  - Effects of applying this guidance . . . 94

L

LONG-LIVED ASSETS
- Impairment . . . 65

LOSS PROVISIONS
- Accrual of anticipated losses . . . 36
- Basic contract price . . . 33
- Change orders . . . 34
- Claims against the owner . . . 35
- Estimated contract revenues . . . 33
- Estimated costs to complete . . . 33
- General considerations . . . 36
- Illustration . . . 37
- Options and additions . . . 35
- Problems in applying GAAP . . . 102

M

MANUFACTURING OPERATIONS—GAAP . . . 101

O

OVERBILLINGS . . . 5

P

PERCENTAGE-OF-COMPLETION METHOD—GAAP
- Alternatives A and B 40
- Change orders 34
- Conditions for use 30, 32
- Determination of percentage complete
  - Cost-to-cost method 39
  - Estimated cost to complete 33
  - General guidance 38, 40
  - Uninstalled materials 39
- Illustration 28, 30
- Interim reporting 32
- Loss contract 36
- Zero profit margin method 31

PROFIT CENTER
- Combining contracts 7, 35
- General guidance 6, 8
- Segmenting contracts 7

R

RETENTIONS 102

REVENUE RECOGNITION
- Authoritative literature 28, 30
- Departures from the basic policy 32
- GAAP 5
- Loss contracts 36
- Methods illustrated
  - Completed-contract 29
  - Percentage-of-completion 28

S

S CORPORATIONS
- Disclosures—illustrations 67
- Sureties—information for 55

SUBCONTRACTOR
- Definition 16
- Retentions 17

SURETY BONDS
- Supplementary information 55

U

UNDERBILLINGS 5

COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 2

CALCULATING INCOME TAX FOR CONSTRUCTION CONTRACTORS (CONTG102)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course covers how to calculate construction contractor's regular income tax as well as Alternative Minimum Tax (AMT). This course also explains how to apply look-back procedures and also analyze a variety of tax issues facing contractors.

PUBLICATION/REVISION DATE: July 2010

RECOMMENDED FOR: Users of *PPC's Guide to Construction Contractors*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of construction contractors

CPE CREDIT: 7 QAS Hours, 7 Registry Hours
4 CTEC Federal Hours, 0 CTEC California Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

Enrolled Agents: This CPE course is designed to enhance professional knowledge for Enrolled Agents. PPC is a qualified CPE Sponsor for Enrolled Agents as required by Circular 230 Section 10.6(g)(2)(ii).

FIELD OF STUDY: Taxes (4 hours), Accounting (3 hours)

EXPIRATION DATE: Postmark by **July 31, 2011**

KNOWLEDGE LEVEL: Basic

LEARNING OBJECTIVES:

Lesson 1—Calculating Current Income Taxes, AMT, and Look-back

Completion of this lesson will enable you to:
- Calculate current income taxes and Alternative Minimum Tax (AMT).
- Properly apply the look-back requirement to taxpayers who account for long-term contracts under the percentage-of-completion method.
- Identify features of tax forms related to construction contractors.

Lesson 2—Other Tax Issues Facing Contractors

Completion of this lesson will enable you to:
- Recognize components used in calculating deferred taxes.
- Analyze the domestic production activities deduction as well as other tax issues facing contractors.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
CONTG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Calculating Current Income Taxes, AMT, and Look-back

INTRODUCTION

CALCULATING CURRENT INCOME TAXES AND AMT

Once the taxpayer arrives at taxable income in accordance with the requirements of Code Section 460, there is a tendency to think that all of the hard work has been completed and all that remains is a simple calculation of the income tax liability. However, this is not the case with a construction company taxpayer because in addition to the regular tax calculation, the taxpayer has two additional complex calculations—the calculation of alternative minimum tax and the application of the look-back rules. The regular tax and alternative minimum tax requirements are discussed in this section, and the look-back rules are discussed in the next section.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Calculate current income taxes and Alternative Minimum Tax (AMT).
- Properly apply the look-back requirement to taxpayers who account for long-term contracts under the percentage-of-completion method.
- Identify features of tax forms related to construction contractors.

The Revenue Reconciliation Act of 1993 (RRA '93) added an additional tax bracket of 35% for corporations with taxable income in excess of $10,000,000. RRA '93 also imposed a 3% surtax on taxable income between $15,000,000 and $18,333,333. The effect of the surtax is to gradually phase out the graduated rates for corporations with taxable income in excess of $15,000,000. Exhibit 1-1 presents a table that incorporates the surtaxes into the marginal tax rates. The table will be used to calculate current taxes in the HBC case study.

Exhibit 1-1

Table for Calculating Current Taxes for C Corporations[a]

If Taxable Income Is	The Tax Is
First $50,000	15% of taxable income
$50,001 to $75,000	$7,500 plus 25% of the amount over $50,000
$75,001 to $100,000	$13,750 plus 34% of the amount over $75,000
$100,001 to $335,000	$22,250 plus 39% of the amount over $100,000
$335,001 to $10,000,000	34% of taxable income
$10,000,001 to $15,000,000	$3,400,000 plus 35% of the amount over $10,000,000
$15,000,001 to $18,333,333	$5,150,000 plus 38% of the amount over $15,000,000
Over $18,333,333	35% of taxable income

Note:

[a] These rates are in effect as of the publication date of this *Course*. Practitioners should be alert for any subsequent changes to the rates.

* * *

Computation of Regular Tax

The regular tax on HBC's before-tax income is calculated in Exhibit 1-2. It is assumed that no permanent differences exist that would further adjust the pretax amounts to arrive at taxable income. Beyond the regular tax computation,

the taxpayer must also compute the alternative minimum tax for 20X2 before the ultimate tax liability for 20X2 can be determined. The tax liability will be the greater of the tax computed under the regular tax system or the alternative minimum tax. The alternative minimum tax liability is discussed beginning in the next paragraph, and Exhibit 1-4 summarizes HBC's current tax liability after considering AMT.

Exhibit 1-2

Highway and Bridge Company
Computation of Regular Tax

December 31, 20X2

	Tax PC Method	Tax Completed-contract Method
Before-tax income (loss)	$ 312,000	$ (984,000)
Permanent differences	—	—
Taxable income	$ 312,000	$ (984,000)
Taxes using the table at Exhibit 1-1	$ 104,000 [a]	$ -0-

Note:

[a] Rounded. In addition to computing the regular tax, the taxpayer must also compute alternative minimum tax (AMT). The ultimate current tax liability is the greater of regular tax or AMT. Exhibit 1-4 summarizes HBC's current tax liability after considering AMT.

* * *

Alternative Minimum Tax (AMT)

In addition to the numerous changes in computing regular tax for construction contractors introduced by TRA '86, the act also introduced a corporate alternative minimum tax (AMT). The corporate AMT was conceived to ensure that all companies pay at least a minimum amount of tax. Under the AMT rules, a company's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax system. In reality, the AMT rules are structured so that companies calculate two tax amounts: one based on the regular tax rules and a tentative minimum tax (TMT) based on the AMT rules. If the TMT exceeds the regular tax, an additional tax equal to the excess (referred to as the alternative minimum tax) also must be paid.

The corporate alternative minimum tax is calculated by adjusting taxable income as determined in accordance with the regular tax system [primarily Code Section 460 and its regulations for taxpayers with long-term contracts] by certain adjustments and preference items to obtain alternative minimum taxable income (AMTI) and applying a flat 20% rate to AMTI in excess of an exemption amount. The exemption allowed is $40,000, which is reduced by 25% of the amount by which AMTI exceeds $150,000. The calculation is summarized below:

	Taxable income
+ or −	adjustments
+	preference items
−	exemption amount
+ or −	adjusted current earnings adjustment
=	alternative minimum taxable income (AMTI)
×	20%
=	alternative minimum tax

IRS Form 4626 is used to compute corporate AMT. Of special concern to contractors is the adjustment to taxable income required by line 2f (long-term contracts entered into after February 28, 1986) and the adjusted current earnings adjustment required by line 4 of Form 4626. Those two adjustments are discussed in greater detail in the following paragraphs.

Exemption from AMT for Small Corporations. The 1997 Taxpayer Relief Act exempts "small corporations" from AMT. For purposes of this exemption, a small corporation is one that, for its first tax year beginning after 1996, has average annual gross receipts of less than $5 million for the three prior tax years. A corporation that meets the initial $5 million gross receipts test will continue to be exempt from the alternative minimum tax as long as its average annual gross receipts do not exceed $7.5 million. Average annual gross receipts is calculated based on a three year average as provided by Code Section 448(c).

If a corporation who was a small corporation later exceeds the average annual gross receipts test, the taxpayer becomes subject to AMT for all future years. However, the long term contract adjustment will apply only to contracts entered into in years after the $7.5 million threshold was exceeded. The depreciation adjustment also applies prospectively. Only assets acquired after the taxpayer is no longer a small corporation are subject to the AMT depreciation and gain (loss) on disposition adjustments.

Mandatory Percentage-of-completion Adjustment. IRC Sec. 56(a)(3) requires that AMTI of taxpayers with long-term contracts entered into after February 28, 1986 be computed on a contract-by-contract basis in accordance with the percentage-of-completion (PC) method. In other words, regardless of what method the taxpayer is allowed to use under IRC Sec. 460 to compute taxable income under the regular tax system, for AMT purposes, the taxable income (AMTI) must be computed using the PC method. This means that a taxpayer who is exempt from the PC method under the small contractor exemption at IRC Sec. 460(e)(1) must nevertheless use the PC method to compute AMTI.

Computing AMT Percentage of Completion. Note that in the preceding citation, the taxpayer must compute percentage of completion in accordance with IRC Sec. 460(b), which states that the cost-to-cost method must be used. For taxpayers who compute regular tax under the PC or PCCC method, that computation will have already been determined because the taxpayer can elect to use the PC method to calculate regular tax for AMT purposes. For taxpayers who are exempt from the PC or PCCC method under IRC Sec. 460(e)(1), the simplified cost allocation procedures of IRC Sec. 460(b)(3) must be used to compute AMT PC.

ACE Adjustment. The adjusted current earnings (ACE) adjustment is a further consideration in calculating AMTI. ACE generally includes all income items, less related expenses, that are permanently excluded from AMTI but which are included in book income. For depreciable property placed in service after December 31, 1993, the ACE depreciation adjustment was repealed by RRA '93. Unfortunately, the calculation must continue to be made for assets placed in service prior to January 1, 1994. However, since most construction assets placed in service prior to January 1, 1994, are now fully depreciated for many contractors, there is no ACE adjustment.

Illustrated AMT Calculations

Exhibit 1-3 illustrates the AMT calculation for HBC. For simplicity, no adjustments or preference items other than the PC adjustment and the ACE adjustment are shown in the illustration.

Exhibit 1-3

Highway and Bridge Company
Calculation of AMT
December 31, 20X2

2005 Form 4626 Line No.	Description	Tax PC Method	Tax Completed-contract Method
1	Taxable income or (loss)	$ 312,000	$ (984,000)
2f	Long-term contracts	(2,497,000)	(1,191,000)
2o	Other adjustment—change to Section 199 deduction	—	(10,000)
	Add AMT PC taxable income.[a]	2,497,000	2,497,000
3	Pre-adjustment AMTI	312,000	312,000
4a	ACE	312,000	312,000
4b	Subtract line 3 from line 4a.	—	—
4c	Multiply line 4b × 75%.	× .75	× .75
4e	ACE adjustment	—	—
5	Add lines 3 and 4e.	312,000	312,000
7	AMTI	312,000	322,000
8	Exemption phase-out computation (If line 7 is $310,000 or more, skip lines 8a and 8b and enter zero on line 8c.)		
8c	Exemption: If zero or less, enter zero.	—	—
9	Subtract line 8c from line 7. If zero or less, enter zero.	312,000	312,000
10	Multiply line 9 × 20%	62,000	62,000
13	Regular tax liability (Exhibit 1-2)	104,000	—
14	AMT: Subtract line 13 from line 12. If zero or less, enter zero.	$ -0-	$ 62,000

Note:

[a] For residential construction contracts entered into after June 20, 1988, the 30% deferred contract income would be subject to AMT.

* * *

The Final Current Tax Liability Is the Greater of Regular Tax or AMT

Exhibit 1-4 summarizes the final current tax liability for HBC. Note that the final liability is the greater of the regular tax or the AMT.

Exhibit 1-4

Highway and Bridge Company
Summary of 20X2 Current Tax Liability

Line No.	Description	Computation	Tax PC Method	Tax Completed-contract Method
1	Regular tax liability	Exhibit 1-2	$ 104,000	$ —
2	AMT	Exhibit 1-3	—	62,000
3	20X2 tax payable	Line 1 + 2	$ 109,000	$ 62,000

* * *

S Corporations and Partnerships

Unlike C corporations that generally are taxpaying entities, S corporations and partnerships are not taxpaying entities; however, they must provide shareholders and partners with information that reflects their share of AMT adjustments. S corporations and partnerships are exempt from the ACE adjustments. However, they must supply their shareholder/partners with details of all AMTI adjustments, including the long-term contract adjustment required by IRC Sec. 56(e)(3). Partnerships also must furnish corporate partners with information regarding their share of the ACE adjustment. There is no small corporation AMT exemption for pass-through entities. Partnerships and S corporations must provide their partners or shareholders with AMT adjustment information regardless of the gross receipts of the entity.

Losses

The computation of AMT is more complex when a loss exists. The AMT guidance in this section should be supplemented with the illustrations and discussions in *PPC's Guide to Accounting for Income Taxes*, which is a helpful tool for addressing loss calculations and other complex AMT issues. For order information, telephone (800) 431-9025 or visit **ppc.thomsonreuters.com**.

AMT Credit

When the AMT exceeds the regular tax, the excess may be carried forward indefinitely to offset the excess of the regular tax over the AMT in future years. That excess, or AMT credit, may not be carried back, nor may the carryforward reduce the tax liability in any year below the tentative AMT. There are limitations on the amount of excess AMT that may be carried forward as a credit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Alex owns a construction company, organized as a C corporation, which had taxable income of $550,000 for 20X6. Compute the regular tax for Alex's construction company.

   a. $173,400.

   b. $187,000.

   c. $192,500.

   d. $197,750.

2. Alpine Construction Co., a C corporation, had $275,000 of taxable income at December 31, 20X3. Compute Alpine Construction's regular tax liability for 20X3.

   a. $41,250

   b. $63,750.

   c. $90,500.

   d. $93,500.

3. Which of the following C corporations would be eligible for the entire $40,000 exemption allowed when computing alternative minimum taxable income (AMTI)?

   a. Ascor, Inc. with an AMTI before exemption amount of $130,000.

   b. Bangor, Inc. with an AMTI before exemption amount of $175,000.

   c. Craig, Inc. with an AMTI before exemption amount of $300,000.

   d. Dunn, Inc. with an AMTI before exemption amount of $350,000.

4. Generally, contractors with long-term contracts must compute AMTI using which of the following methods?

   a. Accrual method.

   b. Cash method.

   c. Completed contract method.

   d. Percentage-of-completion method.

5. The following is selected line items from Acorn Construction's calculation of AMT on Form 4626.

Line No.	Tax PC Method
9	$ 315,000
10	63,000
13	106,100

According to the above information what amount would be listed as AMT on line 14?

a. $0.

b. $43,100

c. $63,000.

d. $106,100.

6. BridgeCo computed a regular tax liability of $62,000 and tentative minimum tax (TMT) of $45,000 for 20X4. What amount will BridgeCo record as their 20X4 taxes payable?

a. $45,000.

b. $62,000.

c. $107,000.

7. Which of the following business entities generally must take into account ACE adjustments when calculating AMTI?

a. Partnerships.

b. C Corporations.

c. S Corporations.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Alex owns a construction company, organized as a C corporation, which had taxable income of $550,000 for 20X6. Compute the regular tax for Alex's construction company. **(Page 119)**

   a. $173,400. [This answer is incorrect. The $40,000 exemption does not apply to the regular tax computation.]

   b. $187,000. [This answer is correct. Regular tax for taxable income of $550,000 would be computed as follows: $550,000 × 34% = $187,000.]

   c. $192,500. [This answer is incorrect. This answer incorrectly multiplies taxable income by 35%. This percent is used for taxable incomes greater than $18,333,333.]

   d. $197,750. [This answer is incorrect. This answer incorrectly multiplies taxable income over $100,000 by 39% and then adds $22,250, a rate not used for taxable income greater than $335,000.]

2. Alpine Construction Co., a C corporation, had $275,000 of taxable income at December 31, 20X3. Compute Alpine Construction's regular tax liability for 20X3. **(Page 119)**

   a. $41,250. [This answer is incorrect. This answer incorrectly applies the 15% tax rate which only applies to the first $50,000 of taxable income.]

   b. $63,750. [This answer is incorrect. This answer improperly applies the tax rules regarding taxable income between $50,001 and $75,000.]

   c. $90,500. [This answer is correct. Alpine Construction's regular tax liability equals ($175,000 × 39%) + $22,250.]

   d. $93,500. [This answer is incorrect. This answer uses the tax rate that corresponds to income between $335,000 and $10 million.]

3. Which of the following C corporations would be eligible for the entire $40,000 exemption allowed when computing alternative minimum taxable income (AMTI)? **(Page 120)**

   a. Ascor, Inc. with an AMTI before exemption amount of $130,000. [This answer is correct. Ascor Inc. is allowed the full exemption amount of $40,000, because their AMTI does not exceed $150,000.]

   b. Bangor, Inc. with an AMTI before exemption amount of $175,000. [This answer is incorrect. Because Bangor Inc.'s AMTI exceeds $150,000 they would receive a reduced exemption amount equal to [$40,000 – ($25,000 × 25%)] = $33,750.]

   c. Craig, Inc. with an AMTI before exemption amount of $300,000. [This answer is incorrect. Craig Inc. is eligible for a reduced exemption amount calculated as follows: [$40,000 − (150,000 × 25%)] = $2,500.]

   d. Dunn, Inc. with an AMTI before exemption amount of $350,000. [This answer is incorrect. Dunn Inc. would not be eligible for an exemption because their AMTI is too great. {[40,000 − (200,000 × 25%)] = $-10,000.}]

4. Generally, contractors with long-term contracts must compute AMTI using which of the following methods? **(Page 121)**

   a. Accrual method. [This answer is incorrect. Small contractors are allowed to use this method for computing regular tax but not for AMT purposes.]

   b. Cash method. [This answer is incorrect. Small contractors and residential construction contractors are allowed to use the cash method when computing regular tax, a contractor is not allowed to use this method when computing AMT.]

   c. Completed contract method. [This answer is incorrect. Small contractors are not allowed to use this method when computing AMTI; they may use the completed contract method to compute regular tax.]

   d. Percentage-of-completion method. [This answer is correct. Regardless of what method the taxpayer is allowed to use under IRC Sec. 460 to compute taxable income under the regular tax system, for AMT purposes, the taxable income (AMTI) must be computed using the PC method when the corporation entered into long-term contracts after February 28, 1986.]

5. The following is selected line items from Acorn Construction's calculation of AMT on Form 4626.

Line No.	Tax PC Method
9	$ 315,000
10	63,000
13	106,100

   According to the above information what amount would be listed as AMT on line 14? **(Page 122)**

   a. $0. [This answer is correct. A company's tax liability is the greater of taxes calculated using either the regular tax system or the alternative minimum tax system; because the regular tax amount on line 13 exceeds the projected AMT amount on line 10, no AMT is recorded on line 14.]

   b. $43,100. [This answer is incorrect. The excess of regular tax over the tentative minimum tax is irrelevant.]

   c. $63,000. [This answer is incorrect. This amount represents the tentative minimum tax (TMT).]

   d. $106,100. [This answer is incorrect. This amount represent the regular tax liability not the amount that would be listed as AMT on line 14.]

6. BridgeCo computed a regular tax liability of $62,000 and tentative minimum tax (TMT) of $45,000 for 20X4. What amount will BridgeCo record as their 20X4 taxes payable? **(Page 123)**

   a. $45,000. [This answer is incorrect. This amount represents the TMT which is used to determine if an AMT amount exists.]

   b. $62,000. [This answer is correct. Since the TMT amount is less than the regular tax calculation no AMT exists. A company's tax liability is the greater of taxes calculated between the regular tax system and the alternative minimum tax system.]

   c. $107,000. [This answer is incorrect. Had the $45,000 represented AMT instead of TMT this answer would have been correct.]

7. Which of the following business entities generally must take into account ACE adjustments when calculating AMTI? **(Page 123)**

   a. Partnerships. [This answer is incorrect. While partnerships are exempt from ACE adjustments, they must furnish corporate partners with information regarding their share of the ACE adjustment.]

   b. C Corporations. [This answer is correct. C Corporations are taxpaying entities that consider ACE adjustments when calculating AMTI.]

   c. S Corporations. [This answer is incorrect. S Corporations are exempt from ACE adjustments. However, they must supply their shareholders with details of all AMTI adjustments, including the long-term contract adjustment required by IRC Sec. 56(e)(3).]

LOOK-BACK

IRC Sec. 460(b)(2) introduced the look-back requirement for taxpayers who account for long-term contracts under the PC method. Under the look-back rules, at the completion of each contract the taxpayer must "look back" to the prior taxable years in which the contract was in progress, and recompute the gross profit (loss) for those previous years based upon the actual, rather than the estimated, total contract price and cost ("hypothetical taxable income"). To the extent that a prior year's gross profit on each completed contract was over (under) estimated, taxable income and alternative minimum taxable income for the prior period are restated and the tax liability is recomputed ("hypothetical tax"). For this purpose, the taxpayer must take into account all applicable additions to tax, credits, and net operating loss (NOL) carrybacks and carryovers.

Because of the hypothetical nature of look-back and recalculation of all items (tax, AMT, credits, NOLs, etc.) in the tax calculation, a separate tax system, similar to AMT, is needed to properly account for look-back.

If the look-back calculation shows that a prior year's liability was understated, the taxpayer owes interest on the understatement. Conversely, to the extent that a prior year's tax liability was overstated, the taxpayer is due a refund. The interest due or refundable must be computed at the overpayment rate determined under IRC Sec. 6621(a)(1) and be compounded on a daily basis from the due date (not including extensions) of the prior year's return to the due date (not including extensions) of the return for the year of contract completion. The look-back rate is changed only once for each twelve month period (the interest accrual period). The interest rate to be used for this twelve-month period is the rate in effect for the calendar quarter in which the interest rate accrual begins.

For purposes of enforcing compliance, the look-back interest due is considered a tax. Failure to comply with the look-back requirement can result in assessment of penalties and interest. However, for purposes of underpayment of estimated tax penalties, it is not included in the tax. The requirement that look-back take into account all applicable adjustments to tax including the effect of net operating losses and credits can lead to complex calculations when there are losses in prior years—recalculation of net operating losses and the tax effect of loss carrybacks or carryforwards, use of alternative minimum tax and other credits, etc. Where NOLs are involved, the time period during which the look-back interest is calculated may be adjusted. If a prior NOL was carried back, interest will accrue from the due date of the tax return for the year that generated the NOL carryback (not the year in which the loss was absorbed). However, if the prior NOL was carried forward, interest will accrue only from the tax year in which the loss is absorbed.

The regulations specify that the first look-back computations must be performed no later than the tax year in which the contract is complete and is available for use by the owner (even if additional costs are reasonably expected). Additional look-back computations must be performed if "post-completion" revenues are received or expenses are incurred after the initial look-back computation. Post-completion revenues and expenses are discussed in more detail later.

Regulations Relating to Look-back

In October 1990, the IRS issued final regulations relating to most look-back issues. The section relating to mid-contract changes in taxpayers was not included. Final regulations relating to mid-contract changes were issued in May 2002.

De Minimis (Small Contract) Exception

In general, a contractor must apply the look-back method to any income from a long-term contract required to be reported under the percentage-of-completion method pursuant to Code Section 460. Similarly, a contractor who is exempt from the required use of the percentage-of-completion method is also exempt from the look-back rules for regular tax purposes. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88) created an additional *de minimis* exception to the application of the look-back rules. This exception is mandatory. That is, the regulation precludes application of the look-back rules by a percentage-of-completion contractor if the exception is met. The regulation states that look-back may not be used for any contract if (a) the gross price of the contract at completion does not exceed the lesser of $1 million, or 1% of the average annual gross receipts of the taxpayer for the three years preceding the completion year, and (b) the contract is completed within two years of the contract commence-

ment date. The exception applies for both regular tax and AMT purposes. Contractors with contracts likely to meet this exception should take care not to overestimate tax liability since interest on tax overpayments will not be available under look-back.

De Minimis Election

The 1997 Taxpayer Relief Act added an election allowing taxpayers to elect out of look-back for *de minimis* contracts completed in tax years ending after August 5, 1997. Taxpayers may elect to forego the look-back method and avoid the interest computation if estimated income recognized in each year of the contract is within 10% of the actual income for each contract year, as calculated based on the look-back rules discussed in the previous paragraphs. This provision is elective and, once made, applies to all long term contracts completed during the election year and for all subsequent years. To determine if a contract may be excluded from look-back, the taxpayer must make all of the look-back calculations for the contract. As a result, the authors expect little time savings to be achieved in preparing the contractor's tax return if the election is made.

Simplified Marginal Impact Method

Mandatory and Elective Use. The regulations provide a "Simplified Marginal Impact Method" (SMIM) for calculating look-back interest. SMIM must be used by any non-closely held partnership, S corporation, or trust to report income on behalf of its owners from domestic contracts completed or adjusted after the effective date. Conversely, a closely held pass through entity cannot elect or otherwise use SMIM to report look-back adjustments on behalf of its owners. A pass-through entity is closely held for this purpose (thus exempt from mandatory use of SMIM) if 50% or more of the entity is owned directly or indirectly by five or fewer persons. A contract is a "domestic contract" if 95% or more of the gross income is from sources within the U.S. . Any taxpayer for whom the SMIM is not mandatory under the above rules may elect to use this method. The election is irrevocable and is made by attaching a statement to the return for the first tax year the election is to apply.

Operation of SMIM. Under SMIM, actual income received from completed contracts is reallocated to each taxable year just as in the regular look-back method. Under SMIM, however, the procedure for redetermining tax liability is modified. Instead of recomputing tax liability for each year, the contractor merely determines an amount of tax on the net increase or decrease in income resulting from the reallocation. The tax rate to be applied to the net increase or decrease is the highest tax rate applicable to the taxpayer in effect for that year. (If multiplying the alternative minimum tax rate by the increase or decrease in alternative minimum taxable income produces a greater amount, the taxpayer must use the greater amount whether or not the taxpayer would have been subject to the AMT.) Under the mandatory use of SMIM, the method must be applied at the pass-through entity level rather than the owners' level . As noted above, however, an owner in a pass-through entity that is not required to use SMIM may elect to use SMIM. Such electing taxpayers apply SMIM at the owners' level. Finally, SMIM imposes an "overpayment ceiling" on electing taxpayers. This ceiling limits the calculated tax overpayment to the contractor's federal tax liability for the redetermination year less any net overpayments resulting from earlier look-back applications to that year. For example, if the contractor's federal tax liability for the redetermination year was $40,000, the ceiling limits the interest refund to the taxpayer to the interest on $40,000. If we further assume that an earlier look-back resulted in a computed tax overpayment of $10,000, the ceiling now limits the interest refund to the taxpayer to the interest on $30,000. This ceiling does not apply to widely held pass-through entities that are required to use SMIM.

Election to Use the 10% Method

A taxpayer required to use the percentage-of-completion method may elect to use the "10% method" to defer gross profit on contracts until the year in which 10% of estimated total contract costs have been incurred (10% year). Contractors electing this 10% method must also use the 10% method when computing look-back interest. For this computation, actual total contract costs are used to determine the 10% year. Therefore, the 10% year for look-back purposes may differ from the originally estimated 10% year. When this new 10% year precedes the original 10% year, contract costs must be reallocated to the new 10% year and to subsequent years according to when the costs were incurred. If the new 10% year is later than the original 10% year, contract costs incurred before the new 10% year must be reallocated to the new 10% year. This provision can work for or against the contractor.

Claims, Change Orders, Performance Bonuses, and Other Contingencies

In some situations, a taxpayer may be permitted to treat a change order as a separate contract. The rule, included in Regulation 1.460-1(e)(2), considers many factors and it is primarily a "facts and circumstances" test. Change orders which are not considered separate contracts, incentive fees, and claims should be taken into income as part of the contract price under the percentage-of-completion method and look-back rules when the amounts to be received are reasonably determinable.

Post-completion Revenue and Expenses

Delayed Application Rule. Where two or more post-completion adjustments occur, a taxpayer may elect to defer the reapplication of look-back (after the initial look-back is done in the year the contract is complete) for a period of up to five years, unless one of the following conditions occurs before the five years is up:

a. the net undiscounted value of the post-completion adjustments occurring since the time of the last look-back exceeds the lesser of $1 million or 10% of the total contract price or total actual contract costs as of that time,

b. the taxpayer goes out of existence, or

c. the taxpayer reasonably believes the contract is finally closed.

The contractor should carefully monitor the contracts to be certain filing conditions have not occurred. Post-completion adjustments may be discounted as discussed in the next paragraph. Post-completion adjustments are illustrated later.

Discounting. IRC Sec. 460(b)(2) provides for the discounting of post-completion adjustments. No discounting is permitted for revenue earned and costs incurred in the year the contract is completed. A taxpayer may elect *not* to discount for any contract. Once such an election is made, it is binding for all post-completion adjustments with respect to that contract. The election not to discount must be made in the first tax period in which a post-completion adjustment occurs and is made by attaching a statement to a timely filed return (including extensions).

The discount will lower the value of post-completion revenue or expenses which are used in look-back computations. Unless the contractor elects *not* to discount post-completion revenue or expenses for a particular contract, they must be discounted from the date they are incurred back to the contract completion date using the Federal mid-term rate under IRC Sec. 1274(d) in effect at the date the adjustment becomes known. However, because the specific contract completion date will not always be readily determinable, taxpayers are permitted to use the end of the two taxable periods. In this case, the Federal mid-term rate is the rate at the end of the year the adjustment takes place. If the end-of-period discounting approach is used for any contract, it must be used for all post-completion adjustments to all contracts during that year.

The discounting of revenue will result in a lower amount of additional gross profit for look-back purposes. The discounting of expenses, on the other hand, will result in a greater amount of gross profit (or a smaller loss). In many cases, post-completion adjustments will include both revenue and expenses. As previously discussed, a contractor may elect *not* to discount post-completion activity for some contracts even though such activity is discounted for other contracts. The most favorable approach is usually to discount all post-completion activity for contracts expected to have net post-completion revenues and not to discount any such activity for contracts that are expected to have net post-completion expenses.

Look-back Step One—Redetermination of Prior Year Gross Profit

The first step in the look-back calculation is to reallocate income from each contract completed in the current year to the prior tax years in which the contract was in progress. For this purpose the actual final contract price and costs are used. The formula is as follows:

$$\frac{\text{Actual contract costs to date}}{\text{Total actual final contract costs}} \times \text{Final gross profit} = \text{Actual contract gross profit or loss to date}$$

The redetermined contract gross profit for each contract is then compared to the contract gross profit as previously reported to determine the contract adjustment for the tax year. The adjustment is referred to as "the hypothetical contract adjustment." Exhibit 1-5 illustrates the look-back contract adjustment calculation at December 31, 20X2 for HBC.

Exhibit 1-5

Highway and Bridge Company
Computation of Look-back Gross Profit

December 31, 20X2

Line No.	Description	Computation	Contracts				Total
	Job number		# 265	# 268	# 269	# 270	
	Job manager		S. Brown	L. Sanders	S. Brown	G. Ortiz	
	Customer		Route 111	Silver Bridge	Hwy 75	Lake Bridge	
	Commencement date		9-30-X1	11-30-X1	2-28-X2	11-30-X2	
	Completion date		7-30-X2	2-28-X3	7-31-X3	—	
	20X1						
1	Contract price		$ 5,000,000	$ 13,800,000	$ N/A	$ N/A	
2	Estimated total costs		3,700,000	10,400,000	N/A	N/A	
3	Total gross profit (loss)	1 − 2	1,300,000	3,400,000	N/A	N/A	
4	Actual costs		1,700,000	1,600,000	N/A	N/A	
5	Cost-to-cost % complete	4 ÷ 2	46%	15%	N/A	N/A	
6	20X1 gross profit	5 × 3	598,000	510,000	N/A	N/A	
	20X2						
7	Revised contract price		5,500,000	15,300,000	17,800,000	8,500,000	
8	Estimated total costs		4,309,000	12,627,000	17,926,000	7,308,000	
9	Revised gross profit (loss)	7 − 8	1,191,000	2,673,000	(126,000)	1,192,000	
10	Actual costs during 20X2		2,609,000	9,897,000	9,367,000	302,000	
11	Actual cumulative costs	10 + 4	4,309,000	11,497,000	9,367,000	302,000	

Line No.	Description	Computation	Contracts				Total
12	Cost-to-cost % complete	11 ÷ 8	100%	91%	52%	4%	
13	20X2 cumulative gross profit (loss)	12 × 9	1,191,000	2,432,000	(66,000)	48,000	
14	20X2 gross profit (loss)	13 − 6	593,000	1,922,000	(66,000)	48,000	
15	20X1 look-back % complete	4 ÷ 8	39%	N/A	N/A	N/A	
16	20X1 look-back gross profit (loss)	15 × 9	464,000	N/A	N/A	N/A	
17	20X1 gross profit over (under) stated	6 − 16	$ 134,000	$ N/A	$ N/A	$ N/A	$134,000
			*	*	*		

For contracts that have to look back for more than one year, the sum of redetermined contract gross profit for each prior reallocation year is subtracted from contract gross profit determined. The result is the hypothetical adjustment for each year.

Look-back Step Two—Calculation of Hypothetical Over/Understatement of Tax

The second step in the look-back calculation is to calculate the hypothetical overpayment or underpayment of regular and alternative minimum tax for each year of the contract based on the hypothetical contract adjustment. The overpayment or underpayment of tax is referred to as the "hypothetical tax adjustment." When making this calculation the taxpayer must take into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. When losses and credits are involved, the calculation can become a complex process.

Form 8697. Once prior years' revised gross profit amounts are computed, they are added to or subtracted from prior years' taxable income to determine any over/understatement of those years' tax liability. IRS Form 8697 is used for that purpose.

Look-back Step Three—Calculation of Look-back Interest

The final step in the look-back calculation is to determine the net interest payable or refundable to the taxpayer using IRS Form 8697. This phase of the calculation can be as time-consuming as the previously discussed look-back computations, especially if the taxpayer wishes to arrive at a precise interest amount. The complexity arises because the interest due or refundable must be computed at the corporate overpayment rate determined under IRC Sec. 6621(a)(1) and compounded daily from the due date of the return (not including extensions) for the prior period to the due date of the return for the year the contract is completed. (The actual interest computation begins on the day after the due date.) For C corporations separate interest computations must be made for "tax" of $10,000 or less and tax amounts over $10,000 for each look-back year. For tax years ending after August 5, 1997, the interest computation has been modified. Rather than using the rates in effect for each quarter, the look-back rate will change only once for each twelve month period (referred to as the "interest accrual period"). The interest rate to be used for this period is the rate in effect for the calendar quarter in which the interest rate accrual begins. (Note: The IRS will compute and pay additional interest to the date the overpayment is refunded.) A present value software program is of immeasurable assistance when performing this part of look-back. The IRS tables of interest factors for compounding interest as set forth in Rev. Proc. 83-7 may be used to manually calculate the refund or amount due. An illustration of the look-back calculation for HBC is presented in Exhibit 1-6 and Exhibit 1-7.

Exhibit 1-6

Highway and Bridge Company
20X1 Tax Provision

Line No.	Description	Computation	Tax PC Method
1	20X1 before tax income		$ 100,000
2	Permanent differences		—
3	Temporary differences [GAAP PC less than (greater than) tax return method]		
	Contract No. 265		—
	Contract No. 268		170,000
4	Taxable income	1 ± 2 ± 3	270,000
5	20X1 tax liability under regular tax system (assume same rates as in Exhibit 1-1)		89,000
	AMT calculation		
6	Taxable income under regular tax system	line 4	270,000
7	AMT adjustments: Tax PC method in excess of (less than) method used for regular tax		—
8	Tax preference items		—
9	AMTI before ACE adjustment	6 ± 7 ± 8	270,000
10	ACE adjustment		—
11	AMTI	9 + 10	270,000
12	AMT exemption [40,000 − (25% × AMTI − 150,000)]		(10,000)
13	AMTI net of exemption	11 − 12	260,000
14	AMT flat rate		20 %
15	AMT	13 × 14	52,000
16	20X1 tax liability (greater of regular tax or AMT)	line 5 or 15	$ 89,000

* * *

Look-back Calculations for Post-completion Adjustments

Exhibit 1-5 through Exhibit 1-7 illustrate, among other things, the effects of look-back for 20X2. Exhibit 1-8 illustrates what the look-back calculations might look like for 20X3 based on the following:

- A dispute relating to contract 265 (which was completed in 20X2) was settled in fiscal 20X3 resulting in additional post-completion revenue of $220,000 and costs of $165,000.
- An election not to discount has not been made. Therefore, discounting of the post-completion activities is required.
- The Federal mid-term rate as of the end of 20X3 is assumed to be 10%. The post-completion revenue of $220,000 is discounted to $200,000 ($220,000 discounted at a 10% rate for one year) resulting in a revised contract price of $5,700,000 ($5,500,000 + $200,000).
- The post-completion expense of $165,000 is discounted to $150,000 ($165,000 discounted at a 10% rate for one year) resulting in a revised total contract cost of $4,459,000 ($4,309,000 + $150,000).

Exhibit 1-7

Highway and Bridge Company
Look-back Calculation Worksheet

December 31, 20X2

Line No.	Description	Computation	Tax PC Method
1	Taxable income of prior year	Exhibit 1-6	$ 270,000
2	Look-back (over-) understatement of prior year	Exhibit 1-5	(134,000)
3	Adjusted look-back taxable income	1 ± 2	136,000
4	Look-back regular tax using prior year rates		36,000
	AMT look-back calculation		
5	Adjusted taxable income—regular tax system	3	136,000
6	AMT adjustments: Tax PC method in excess of (less than) method used for regular tax		—
7	Tax preference items		—
8	AMTI before ACE adjustment	3 ± 6 + 7	136,000
9	ACE adjustment		—
10	AMTI	8 + 9	136,000
11	AMTI exemption [40,000 − (25% × AMTI − 150,000)]		(40,000)
12	AMTI net of exemption	10 − 11	96,000
13	AMT flat rate		20 %
14	Look-back tentative minimum tax	12 × 13	19,000
15	20X1 look-back tax liability (greater of regular tax or AMT)	4 or 14	36,000
16	Income tax liability on previous return	Exhibit 1-6	89,000
17	Increase (decrease) in tax for the prior year on which interest is due (or refundable)	15 − 16	(53,000)
18	Interest rate (IRS rates are set quarterly and at this time are unknown for future periods. An assumed rate of 6% is used for illustration purposes.)[a]		6 %
19	Look-back time period (number of days)		365
20	Interest payable (refundable)	17 × 18 ÷ 365 × 19	$ (3,180)

Note:

[a] Since the change in tax exceeds $10,000, there would be two separate interest calculations: (1) interest on the initial $10,000 and (2) interest on the $43,000 balance of tax. Assuming that these rates are 6% and 4.5% respectively, the interest to be refunded would be $2,600.

* * *

Exhibit 1-8

Highway and Bridge Company
Look-back Calculation Worksheet for Contract 265

December 31, 20X3

Line No.	Description	Computation or Reference	Amount
1	Revised contract price		$ 5,700,000
2	Revised contract costs		4,459,000
3	Revised gross profit	1 – 2	1,241,000
4	20X1 actual costs	Exhibit 1-5, line 4	1,700,000
5	20X1 look-back % complete	4 ÷ 2	38 %
6	20X1 look-back gross profit	5 × 3	472,000
7	20X1 look-back gross profit for 20X2	Exhibit 1-5, line 16	464,000
8	20X1 gross profit understated	6 – 7	8,000
9	20X2 actual cumulative costs	Exhibit 1-5, line 11	4,309,000
10	20X2 look-back % complete	9 ÷ 2	97 %
11	20X2 look-back cumulative gross profit	10 × 3	1,204,000
12	20X2 gross profit	Exhibit 1-5, line 13	1,191,000
13	20X2 cumulative look-back gross profit understated	11 – 12	13,000
14	20X2 look-back gross profit understated	13 – 8	$ 5,000

* * *

Based on Exhibit 1-8, HBC should attach a Form 8697 to its 20X3 Federal income tax return. The Form 8697 will reflect for contract #265 an adjustment to taxable income for 20X1 of $8,000 and for 20X2 of $5,000. Look-back for other contracts, if applicable, will also be included. Instructions to the form require attached schedules showing amounts for each contract when more than one contract has a look-back computation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

8. If a look-back calculation shows that a prior year's liability was understated:

    a. The taxpayer owes interest on the understatement.

    b. The taxpayer is due a refund.

    c. The taxpayer will overstate the current year's liability.

    d. The taxpayer will correct the previous year's understatement, by filing an amended return.

9. Select the contract exempt from the look-back requirement based on the *de minimis* exception.

    a. Contract A: gross price of contract at completion $1.5 million.

    b. Contract B: completed four years after the contract commencement date.

    c. Contract C: completed 12 months after the contract commencement date.

    d. Contract D: gross price of contract at completion $500,000 and completed 3 years after the commencement date.

10. All of the following are conditions that prevent the delayed application rule from being applied **except:**

    a. The taxpayer goes out of existence.

    b. The taxpayer reasonably believes the contract is finally closed.

    c. The taxpayer applied the initial look-back in the year the contract is complete.

    d. The net undiscounted value of the post-completion adjustments occurring since the time of the last look-back exceeds the lesser of $1 million or 10% of the total contract price or total actual contract costs as of that time.

11. Discounting, provided by IRC Sec. 460(b)(2), is permitted for which of the following?

    a. Post-completion adjustments.

    b. Revenue earned in the year the contract is completed.

    c. Costs incurred in the year the contract is completed.

    d. A contract with which an election not to discount was made in the first tax period in which a post-completion adjustment occurred.

12. What is the first step in the look-back calculation?

    a. Calculation of look-back interest.

    b. Determine the actual contract price.

    c. Redetermination of prior year gross profit.

    d. Calculation of hypothetical over/understatement of tax.

Use the following information to answer questions 13–14.

Elbow Construction has the following information related to 20X2 and 20X3.

Look-back Calculation Worksheet
December 31, 20X3

Taxable income of prior year	$ 245,000
Look-back overstatement of prior year	(100,000)
Adjusted look-back taxable income	145,000
Look-back regular tax using prior year rates	39,800
Look-back tentative minimum tax	21,000
20X2 look-back tax liability	
Income tax liability on previous return	78,800
Increase/Decrease in tax for the prior year on which interest is due or refundable	
Interest rate	6%
Look back time period	365 days
Interest payable or refund	

13. What amount should appear as Elbow Construction's 20X2 look-back tax liability?

    a. $18,800.

    b. $21,000.

    c. $39,800.

14. What amount will Elbow Construction owe or receive in interest based on the look-back calculation?

    a. Owe $2,340.

    b. Owe $3,468.

    c. Receive $3,468.

    d. Receive $2,340.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

8. If a look-back calculation shows that a prior year's liability was understated: **(Page 130)**

   a. The taxpayer owes interest on the understatement. [This answer is correct. If a look-back calculation shows that a prior year's liability was understated, the taxpayer owes interest on the understatement. The interest due is determined at the overpayment rate determined under IRC Sec. 6621 (a)(1).]

   b. The taxpayer is due a refund. [This answer is incorrect. To the extent that a prior-year's tax liability was overstated, the taxpayer is due a refund.]

   c. The taxpayer will overstate the current year's liability. [This answer is incorrect. Under the look-back rules, at the completion of each contract the taxpayer must "look back" to the prior taxable years in which the contract was in progress, and recompute the gross profit. An understatement of a prior-year's liability cannot be fixed by overstating the completed contract in the current year.]

   d. The taxpayer will correct the previous year's understatement, by filing an amended return. [This answer is incorrect. After determining that the previous year's liability was understated though the use of the look-back calculation, a taxpayer is not allowed to correct the understated liability on the prior-year's return.]

9. Select the contract exempt from the look-back requirement based on the *de minimis* exception. **(Page 130)**

   a. Contract A: gross price of contract at completion $1.5 million. [This answer is incorrect. For a contract to be exempt from the look-back requirement the gross price of the contract at completion cannot exceed the lesser of $1 million or 1% of the average annual gross receipts of the taxpayer for the three years preceding the completion year.]

   b. Contract B: completed four years after the contract commencement date. [This answer is incorrect. A contract completed four years after the contract commencement date does not meet the requirement for the *de minimis* exception per the Technical and Miscellaneous Revenue Act of 1988 (TAMRA '88).]

   c. Contract C: completed 12 months after the contract commencement date. [This answer is correct. This contract would be exempt from the look-back requirements because it was completed within two years of the contract commencement date.]

   d. Contract D: gross price of contract at completion $500,000 and completed 3 years after the commencement date. [This answer is incorrect. This contract would still have to apply look-back procedures even though its gross price of contract at completion was $500,000 because it took longer than two years to complete the contract after the commencement date.]

10. All of the following are conditions that prevent the delayed application rule from being applied **except: (Page 132)**

    a. The taxpayer goes out of existence. [This answer is incorrect. A taxpayer may elect to defer the reapplication of look-back for up to five years. If during this time the taxpayer goes out of existence the delayed application is voided.]

    b. The taxpayer reasonably believes the contract is finally closed. [This answer is incorrect. If during the five year period in which a taxpayer can defer reapplication of look-back the taxpayer reasonably believes the contract is finally closed, look-back can no longer be deferred.]

    c. The taxpayer applied the initial look-back in the year the contract is complete. [This answer is correct. In order for a taxpayer to delay the reapplication of look-back after two or more post-completion adjustments occur they must have applied the initial look-back in the year the contract was complete.]

    d. The net undiscounted value of the post-completion adjustments occurring since the time of the last look-back exceeds the lesser of $1 million or 10% of the total contract price or total actual contract costs as of that time. [This answer is incorrect. This answer represents a condition that will cease the use of the delayed application rule.]

11. Discounting, provided by IRC Sec. 460(b)(2), is permitted for which of the following? **(Page 132)**

    a. Post-completion adjustments. [This answer is correct. IRC Sec. 460(b)(2) provides for the discounting of post-completion adjustments. Once such an election is made, it is binding for all post-completion adjustments with respect to that contract.]

    b. Revenue earned in the year the contract is completed. [This answer is incorrect. No discounting is permitted for revenue earned in the year the contract is completed.]

    c. Costs incurred in the year the contract is completed. [This answer is incorrect. Costs incurred in the year the contract is completed is not eligible for discounting under IRC Sec. 460(b)(2).]

    d. A contract with which an election not to discount was made in the first tax period in which a post-completion adjustment occurred. [This answer is incorrect. Once such an election is made, it is binding for all post-completion adjustments with respect to that contract.]

12. What is the first step in the look-back calculation? **(Page 133)**

    a. Calculation of look-back interest. [This answer is incorrect. The final step in the look-back calculation is to determine the net interest payable or refundable to the taxpayer using IRS Form 8697.]

    b. Determine the actual contract price. [This answer is incorrect. Determining the actual contract price is a step followed when redetermining the prior year's gross profit.]

    c. Redetermination of prior year gross profit. [This answer is correct. The first step in the look-back calculation is to reallocate income from each contract completed in the current year to the prior tax years in which the contract was in progress.]

    d. Calculation of hypothetical over/understatement of tax. [This answer is incorrect. The second step in the look-back calculation is to calculate the hypothetical overpayment or underpayment of regular and alternative minimum tax for each year of the contract based on the hypothetical contract adjustment.]

13. What amount should appear as Elbow Construction's 20X2 look-back tax liability? **(Page 136)**

    a. $18,800. [This answer is incorrect. According to IRC Sec. 6621(a)(1), the 20X2 look-back liability is not computed as the look-back using prior year tax rates minus the look-back tentative amount.]

    b. $21,000. [This answer is incorrect. According to IRC Sec. 6621(a)(1), the look-back tentative minimum tax does not represent the greater tax liability.]

    c. $39,800. [This answer is correct. When determining a year's tax liability it should represent the greater of regular tax or AMT.]

14. What amount will Elbow Construction owe or receive in interest based on the look-back calculation? **(Page 136)**

    a. Owe $2,340. [This answer is incorrect. While the amount is correct, Elbow Construction does not owe interest on the overstatement of the prior year's gross profit.]

    b. Owe $3,468. [This answer is incorrect. When you subtract the 20X2 look-back tax liability from the income tax liability on the previous return Elbow Construction is eligible for a refund.]

    c. Receive $3,468. [This answer is incorrect. Elbow Construction will be receiving a refund however this amount represents a refund if Elbow Construction had improperly selected the 20X2 look-back tax liability as being $21,000.]

    d. Receive $2,340. [This answer is correct. Elbow Construction's refund is computed as follows: ((($39,800 − $78,800) × 6%) ÷ 365) × 365) = ($2,340).]

Filing Form 8697

For taxpayers that owe look-back interest to the government, Form 8697 is completed and attached to their income tax return. The calculated look-back interest due is shown as additional tax and included in the total tax liability. A Form 8697 filed with a taxpayer's return is not required to be signed. However, if look-back interest is owed to the taxpayer by the government, Form 8697 is filed separately from the income tax return. Because Form 8697 is filed separately, both the taxpayer and the preparer must sign it and file it by the due date (including extensions) of the taxpayer's return. The IRS generally will not process refunds of look-back interest until after the income tax return for the look-back year has been filled.

Form 8697 Noncompliance Issues. In recent years the IRS has begun looking more closely at Forms 8697 and has designated look-back noncompliance as an emerging issue. In August 2004, the Large and Mid-size Business Division (LMSB) of the IRS issued a memorandum to LMSB directors and managers providing information regarding noncompliance of look-back interest under IRC Section 460. The Alert, *Emerging Issue on Look-back Interest for Construction Industry*, and the Construction Industry Audit Technique Guide (ATG) issued by the IRS in May 2009 identify the following as some of the most common errors related to compliance with the look-back interest rules:

- Improperly computing interest from a Net Operating Loss (NOL) carryback year rather than from the year generating the NOL.
- When calculating look-back interest to be paid or refunded, the interest accrual periods are not used (i.e., rates are changed quarterly rather than annually).
- Simplified Marginal Impact Method (SMIM) applied at entity level rather than owner level for taxpayers electing SMIM. A pass-through entity cannot elect or use SMIM to report look-back interest on behalf of its owners.
- Forms with refunds of look-back interest are improperly included with the underlying tax return and reduce tax liability. Forms 8697 with refunds must be separately filed.
- The cumulative changes to look-back taxable income and look-back tax liability for each redetermination year are not properly reported on Form 8697.
- After conversion of a C corporation to an S corporation, improperly reporting look-back at the shareholder level, instead of at the entity level, for contracts entered into prior to the effective date of the conversion.
- Spouse does not sign separately filed Form 8697. Even though only one spouse has an ownership interest in the entity generating the look-back, if a joint income tax return is filed, both spouses must sign Form 8697.

In addition to the look-back issues identified in the Alert and the ATG, other common look-back errors include:

- FEIN or Social Security number does not match name or entity in IRS records.
- Member of a consolidated group filing look-back under its FEIN instead of its parent's FEIN.
- IRS is unable to reconcile tax liability (line 5 of Form 8697) to IRS records (this can occur when there has been a prior look-back adjustment to the tax year).
- Contract schedules are not attached to Form 8697. (Only owners of pass-through entities are exempt from this requirement).
- Overpayment ceiling is not applied when applicable on returns using SMIM.
- The de minimis contract exception is calculated incorrectly. (Gross receipts from related entities or the taxpayer's share of gross receipts from partnerships and joint ventures are not included).

- Loss contracts are calculated incorrectly.
- When look-back interest is due to the taxpayer, Form 8697 is filed before the underlying return is filed. For example, look-back for 20X5 is filed before the taxpayer files a return for 20X5.
- Use of incorrect interest rates.
- After converting a C corporation to an ESOP or an S corporation to an ESOP, failure to subject to look-back contracts entered into prior to becoming an ESOP. Although the ESOP is a non-taxpaying entity, contracts entered into prior to becoming an ESOP are subject to look-back.

Accountants may want to pay particular attention to the above items when a Form 8697 is required for their construction contractor clients.

Since the IRS is looking more closely at Forms 8697, it is important that Form 8697 be completed correctly. To avoid processing delays, taxpayers and their accountants should verify that:

- Line 2 (line 1 for the Simplified Method) agrees with the supporting schedules.
- If the contract adjustment on line 2 (line 1 for the Simplified Method) is negative, line 6 (line 2 for the Simplified Method) should also be negative, and conversely, if line 2 is positive, then line 6 should also be positive.
- If line 6 (using the Regular Method) takes into account NOLs, amended returns, or similar items, then a supporting schedule may be necessary to reconcile the tentative overpayment or underpayment of tax.
- When using the Simplified Method, verify that the taxpayer qualifies for use of the method.
- When using the Simplified Method and the adjustment is negative, verify that the tentative tax adjustment does not exceed the overpayment ceiling.
- When using the Simplified Method, verify that line 2 uses the highest tax bracket for the look-back tax year.

The Interest Refund/Expense Is a Taxable Item

The amount reported as refundable interest on Form 8697 must be shown as interest income on the taxpayer's federal income tax return for the tax year in which it is accrued or received. Likewise, the amount of any interest payable on Form 8697 is deductible in the year accrued or paid, subject to any applicable limitations under Code Section 163. This creates a dilemma for the accountant because, theoretically, prior year look-back must be computed to determine current year pretax income; that is, the look-back interest refund/expense is a taxable item affecting before-tax income. One practical approach to avoid that complexity is to follow cash basis accounting for any look-back interest refund/payable. For example, the 20X1 look-back (which might be computed on or about March 15, 20X3) would be accounted for in 20X3 instead of 20X2. Following that cash basis approach, the 20X2 determination of pretax income would not have to be delayed because of the 20X1 look-back calculation. For GAAP purposes, such cash treatment of look-back is a violation of pure accrual accounting; however, rarely would the look-back amount be material to the entity's financial statements. An overall analytical test can be performed to gauge the magnitude of the look-back by multiplying any prior year misstatement of contract gross profit by the maximum tax rate in effect during those periods. Any under/over payment of taxes would then be multiplied by the maximum interest rate during the period to arrive at a "ballpark" figure for look-back.

For individual taxpayers, Reg. 1.460-6(f) states that look-back interest is treated as personal interest and a deduction is disallowed in accordance with Reg. 1.163-9T. In addition, refund years cannot be netted against years in which look-back interest is due.

In *James E. Redlark and Cheryl Redlark v. Commissioner*, 106 TC 31, dated January 11, 1996, the Tax Court held that the Regulations denying a deduction for individuals for interest on tax deficiencies were invalid. In the *James E. Redlark and Cheryl Redlark v. Commissioner* case, the taxpayers' deficiency arose out of their unincorporated

business (and thus was business, not personal, in nature). This decision was overturned by the U.S. Court of Appeals in April 1998 and the Regulation was upheld. Thus, at the present time, look-back interest paid by individual taxpayers is not deductible.

The final regulations issued May 15, 2002 relating to mid-contract changes in taxpayers address the issue of whether the old taxpayer or the new taxpayer is responsible for reporting and paying or receiving look-back interest when a change in ownership has occurred. These rules are summarized as follows:

a. *Step-in-the-Shoes Transactions.* The look-back method is applied only by the new taxpayer at the time the contract is completed. The new taxpayer must account for both the pre-transaction and post-transaction look-back interest. The new taxpayer is required to file Form 8697 and pay any look-back interest due. In addition, the new taxpayer is entitled to receive any look-back interest to be refunded. Special rules apply for the calculation of look-back interest in pre-transaction tax years. The old taxpayer is required to provide the new taxpayer with information to enable the new taxpayer to make the necessary calculations.

b. *Constructive Completion Transactions.* The old taxpayer must take into account all pre-transaction look-back computations at the time of the transaction and the new taxpayer must take into account any post-transaction look-back computations in the year the contract is completed.

ILLUSTRATED U.S. CORPORATION INCOME TAX RETURN

Exhibit 1-9 illustrates a completed *U.S. Corporation Income Tax Return* Form 1120 for Highway and Bridge Company assuming use of the PC method for the year ended December 31, 2007. Highway and Bridge Company has assets in excess of $10 million and accordingly should complete Schedule M-3, in lieu of completing Schedule M-1. [For tax years ending on or after December 31, 2006, C corporations, S corporations, and partnerships with total assets of $10 million or more, and which file 250 or more tax returns, are required to complete Schedule M-3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 million or More*. The M-1 information has been left in this illustration for those companies that do not meet the requirements to complete Schedule M-3. An example of a Schedule M-3 has been included. In January 2010, the IRS announced it was developing a new schedule for reporting uncertain tax positions (UTP's) on tax returns. The IRS subsequently released a draft of Schedule UTP with instructions in April 2010. If finalized, beginning with the 2010 tax year, certain taxpayers with assets of $10 million or more will be required to file Schedule UTP if they or a related party issue audited financial statements. The draft schedule and instructions require corporations filing Form 1120, among others, to report uncertain tax positions using Schedule UTP. The reporting requirements do not apply to other entities that file Form 1120 (such as real-estate investment trusts and others), or to pass-through entities or tax-exempt organizations.

Exhibit 1-9

U.S. Corporation Income Tax Return

Form **1120** Department of the Treasury Internal Revenue Service

U.S. Corporation Income Tax Return

For calendar year 2009 or tax year beginning _____, 2009, ending _____, 20 ____

▶ See separate instructions.

OMB No. 1545-0123

2009

A Check if:
1a Consolidated return (attach Form 851) ☐
b Life/nonlife consolidated return ☐
2 Personal holding co. (attach Sch. PH) ☐
3 Personal service corp. (see instructions) ☐
4 Schedule M-3 attached ☐

Use IRS label. Otherwise, print or type.

Name: Highway and Bridge Company

Number, street, and room or suite no. If a P.O. box, see instructions.: 1 Straight Place

City or town, state, and ZIP code: Fort Worth, TX 76107

B Employer identification number: 99-9999999

C Date incorporated: 3-9-58

D Total assets (see instructions): $ 10,152,000

E Check if: (1) ☐ Initial return (2) ☐ Final return (3) ☐ Name change (4) ☐ Address change

Income	1a	Gross receipts or sales 24,672,000	b Less returns and allowances	c Bal ▶	1c	$24,672,000
	2	Cost of goods sold (Schedule A, line 8)			2	22,175,000
	3	Gross profit. Subtract line 2 from line 1c			3	2,497,000
	4	Dividends (Schedule C, line 19)			4	
	5	Interest			5	
	6	Gross rents			6	
	7	Gross royalties			7	
	8	Capital gain net income (attach Schedule D (Form 1120))			8	
	9	Net gain or (loss) from Form 4797, Part II, line 17 (attach Form 4797)			9	
	10	Other income (see instructions—attach schedule)			10	
	11	**Total income.** Add lines 3 through 10 ▶			11	2,497,000
Deductions (See instructions for limitations on deductions.)	12	Compensation of officers (Schedule E, line 4) ▶			12	100,000
	13	Salaries and wages (less employment credits)			13	1,750,000
	14	Repairs and maintenance			14	
	15	Bad debts			15	
	16	Rents			16	
	17	Taxes and licenses			17	480,000
	18	Interest			18	
	19	Charitable contributions			19	
	20	Depreciation from Form 4562 not claimed on Schedule A or elsewhere on return (attach Form 4562)			20	70,000
	21	Depletion			21	
	22	Advertising			22	
	23	Pension, profit-sharing, etc., plans			23	240,000
	24	Employee benefit programs			24	
	25	Domestic production activities deduction (attach Form 8903)			25	10,000
	26	Other deductions (attach schedule)			26	(465,000)
	27	**Total deductions.** Add lines 12 through 26 ▶			27	2,185,000
	28	Taxable income before net operating loss deduction and special deductions. Subtract line 27 from line 11			28	312,000
	29	**Less:** a Net operating loss deduction (see instructions)	29a		29c	
		b Special deductions (Schedule C, line 20)	29b			
Tax, Refundable Credits, and Payments	30	**Taxable income.** Subtract line 29c from line 28 (see instructions)			30	312,000
	31	**Total tax** (Schedule J, line 10)			31	104,000
	32a	2008 overpayment credited to 2009	32a 2,000			
	b	2009 estimated tax payments	32b 190,000			
	c	2009 refund applied for on Form 4466	32c ( )	d Bal ▶ 32d	192,000	
	e	Tax deposited with Form 7004		32e		
	f	Credits: (1) Form 2439 (2) Form 4136		32f		
	g	Refundable credits from Form 3800, line 19c, and Form 8827, line 8c		32g		32h 192,000
	33	Estimated tax penalty (see instructions). Check if Form 2220 is attached ▶ ☐			33	
	34	**Amount owed.** If line 32h is smaller than the total of lines 31 and 33, enter amount owed			34	
	35	**Overpayment.** If line 32h is larger than the total of lines 31 and 33, enter amount overpaid			35	83,000
	36	Enter amount from line 35 you want: **Credited to 2010 estimated tax** ▶ 83,000		**Refunded** ▶	36	

Sign Here

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer _____ Date _____ Title _____

May the IRS discuss this return with the preparer shown below (see instructions)? ☐ Yes ☐ No

Paid Preparer's Use Only

Preparer's signature ▶ | Date | Check if self-employed ☐ | Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code ▶ | EIN | Phone no.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11450Q Form **1120** (2009)

Form 1120 (2009) Highway and Bridge Company 99-9999998 Page 2

Schedule A Cost of Goods Sold (see instructions)

1	Inventory at beginning of year		1	22,000.
2	Purchases		2	
3	Cost of labor		3	
4	Additional section 263A costs (attach schedule)	See Statement 3	4	1,925,000.
5	Other costs (attach schedule)	See Statement 4	5	20,268,000.
6	**Total.** Add lines 1 through 5		6	22,215,000.
7	Inventory at end of year		7	40,000.
8	**Cost of goods sold.** Subtract line 7 from line 6. Enter here and on page 1, line 2		8	22,175,000.

9a Check all methods used for valuing closing inventory:
- (i) ☐ Cost
- (ii) ☒ Lower of cost or market
- (iii) ☐ Other (Specify method used and attach explanation.) ▶

b Check if there was a writedown of subnormal goods ▶ ☐

c Check if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970) ▶ ☐

d If the LIFO inventory method was used for this tax year, enter percentage (or amounts) of closing inventory computed under LIFO — 9d

e If property is produced or acquired for resale, do the rules of section 263A apply to the corporation? ☒ Yes ☐ No

f Was there any change in determining quantities, cost, or valuations between opening and closing inventory? If "Yes," attach explanation ☐ Yes ☒ No

Schedule C Dividends and Special Deductions (see instructions)

		(a) Dividends received	(b) %	(c) Special deductions (a) x (b)
1	Dividends from less-than-20%-owned domestic corporations (other than debt-financed stock)		70	
2	Dividends from 20%-or-more-owned domestic corporations (other than debt-financed stock)		80	
3	Dividends on debt-financed stock of domestic and foreign corporations		see instructions	
4	Dividends on certain preferred stock of less-than-20%-owned public utilities		42	
5	Dividends on certain preferred stock of 20%-or-more-owned public utilities		48	
6	Dividends from less-than-20%-owned foreign corporations and certain FSCs		70	
7	Dividends from 20%-or-more-owned foreign corporations and certain FSCs		80	
8	Dividends from wholly owned foreign subsidiaries		100	
9	**Total.** Add lines 1 through 8			
10	Dividends from domestic corporations received by a small business investment company operating under the Small Business Investment Act of 1958		100	
11	Dividends from affiliated group members		100	
12	Dividends from certain FSCs		100	
13	Dividends from foreign corporations not included on lines 3, 6, 7, 8, 11, or 12			
14	Income from controlled foreign corporations under subpart F (attach Form(s) 5471)			
15	Foreign dividend gross-up			
16	IC-DISC and former DISC dividends not included on lines 1, 2, or 3			
17	Other dividends			
18	Deduction for dividends paid on certain preferred stock of public utilities			
19	**Total dividends.** Add lines 1 through 17. Enter here and on page 1, line 4 ▶			
20	**Total special deductions.** Add lines 9, 10, 11, 12, and 18. Enter here and on page 1, line 29b ▶			

Schedule E Compensation of Officers (see instructions for page 1, line 12)

Note: Complete Schedule E only if total receipts (line 1a plus lines 4 through 10 on page 1) are $500,000 or more.

(a) Name of officer	(b) Social security number	(c) Percent of time devoted to business	Percent of corporation stock owned (d) Common	(e) Preferred	(f) Amount of compensation
1 Not illustrated					

2	Total compensation of officers	
3	Compensation of officers claimed on Schedule A and elsewhere on return	
4	Subtract line 3 from line 2. Enter the result here and on page 1, line 12	

Form 1120 (2009) Highway and Bridge Company 99-9999998 Page 3

Schedule J Tax Computation (see instructions)

1	Check if the corporation is a member of a controlled group (attach Schedule O (Form 1120)) ▶ ☐			
2	Income tax. Check if a qualified personal service corporation (see instructions) ▶ ☐ Stmt 5		2	104,930.
3	Alternative minimum tax (attach Form 4626)		3	
4	Add lines 2 and 3		4	104,930.
5a	Foreign tax credit (attach Form 1118)	5a		
b	Credit from Form 8834, line 29	5b		
c	General business credit (attach Form 3800)	5c		
d	Credit for prior year minimum tax (attach Form 8827)	5d		
e	Bond credits from Form 8912	5e		
6	**Total credits.** Add lines 5a through 5e		6	
7	Subtract line 6 from line 4		7	104,930.
8	Personal holding company tax (attach Schedule PH (Form 1120))		8	
9	Other taxes. Check if from: ☐ Form 4255 ☐ Form 8611 ☐ Form 8697 ☐ Form 8866 ☐ Form 8902 ☐ Other (attach schedule)		9	
10	**Total tax.** Add lines 7 through 9. Enter here and on page 1, line 31		10	104,930.

Schedule K Other Information (see instructions)

		Yes	No
1	Check accounting method: a ☐ Cash b ☐ Accrual c ☒ Other (specify) ▶ Statement 1		
2	See the instructions and enter the:		
a	Business activity code no. ▶ 237310		
b	Business activity ▶ Construction		
c	Product or service ▶ Hwys. and bridges		
3	Is the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group?		X
	If "Yes," enter name and EIN of the parent corporation ▶		
4	At the end of the tax year:		
a	Did any foreign or domestic corporation, partnership (including any entity treated as a partnership), trust, or tax-exempt organization own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part I of Schedule G (Form 1120) (attach Schedule G)		X
b	Did any individual or estate own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of the corporation's stock entitled to vote? If "Yes," complete Part II of Schedule G (Form 1120) (attach Schedule G)		X
5	At the end of the tax year, did the corporation:	Yes	No
a	Own directly 20% or more, or own, directly or indirectly, 50% or more of the total voting power of all classes of stock entitled to vote of any foreign or domestic corporation not included on **Form 851**, Affiliations Schedule? For rules of constructive ownership, see instructions If "Yes," complete (i) through (iv).		X

(i) Name of Corporation	(ii) Employer Identification Number (if any)	(iii) Country of Incorporation	(iv) Percentage Owned in Voting Stock

JWA Form **1120** (2009)

911621
12-17-09

Form 1120 (2009) Highway and Bridge Company 99-9999998 Page 4

Schedule K Continued

b Own directly an interest of 20% or more, or own, directly or indirectly, an interest of 50% or more in any foreign or domestic partnership (including an entity treated as a partnership) or in the beneficial interest of a trust? For rules of constructive ownership, see instructions ..... If "Yes," complete (i) through (iv).		X

(i) Name of Entity	(ii) Employer Identification Number (if any)	(iii) Country of Organization	(iv) Maximum Percentage Owned in Profit, Loss, or Capital

6	During this tax year, did the corporation pay dividends (other than stock dividends and distributions in exchange for stock) in excess of the corporation's current and accumulated earnings and profits? (See sections 301 and 316.) ..... If "Yes," file **Form 5452,** Corporate Report of Nondividend Distributions. If this is a consolidated return, answer here for the parent corporation and on Form 851 for each subsidiary.	X
7	At any time during the tax year, did one foreign person own, directly or indirectly, at least 25% of **(a)** the total voting power of all classes of the corporation's stock entitled to vote or **(b)** the total value of all classes of the corporation's stock? ..... For rules of attribution, see section 318. If "Yes," enter: **(i)** Percentage owned ▶ _____ and **(ii)** Owner's country ▶ _____	X
	(c) The corporation may have to file **Form 5472,** Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business. Enter the number of Forms 5472 attached ▶ _____	
8	Check this box if the corporation issued publicly offered debt instruments with original issue discount ..... ▶ ☐ If checked, the corporation may have to file **Form 8281,** Information Return for Publicly Offered Original Issue Discount Instruments.	
9	Enter the amount of tax-exempt interest received or accrued during the tax year ▶ $ _____	
10	Enter the number of shareholders at the end of the tax year (if 100 or fewer) ▶ 6	
11	If the corporation has an NOL for the tax year and is electing to forego the carryback period, check here ..... ▶ ☐ If the corporation is filing a consolidated return, the statement required by Regulations section 1.1502-21(b)(3) must be attached or the election will not be valid.	
12	Enter the available NOL carryover from prior tax years (do not reduce it by any deduction on line 29a.) ▶ $ _____	
13	Are the corporation's total receipts (line 1a plus lines 4 through 10 on page 1) for the tax year **and** its total assets at the end of the tax year less than $250,000? ..... If "Yes," the corporation is not required to complete Schedules L, M-1, and M-2 on page 5. Instead, enter the total amount of cash distributions and the book value of property distributions (other than cash) made during the tax year. ▶ $	X

Form 1120 (2009) Highway and Bridge Company 99-9999998 Page 5

Schedule L Balance Sheets per Books

Assets	Beginning of tax year (a)	Beginning of tax year (b)	End of tax year (c)	End of tax year (d)
1 Cash		330,000.		440,000.
2a Trade notes and accounts receivable	1,618,000.		3,650,000.	
b Less allowance for bad debts	( )	1,618,000.	( )	3,650,000.
3 Inventories		22,000.		40,000.
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets (att. sch.) Stmt 6		712,000.		822,000.
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (att. sch.)				
10a Buildings and other depreciable assets	9,980,000.		10,150,000.	
b Less accumulated depreciation	(4,300,000.)	5,680,000.	(5,000,000.)	5,150,000.
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)		50,000.		50,000.
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (att. sch.)				
15 Total assets		8,412,000.		10,152,000.
Liabilities and Shareholders' Equity				
16 Accounts payable		2,097,000.		3,030,000.
17 Mortgages, notes, bonds payable in less than 1 year		100,000.		100,000.
18 Other current liabilities (att. sch.) Stmt 7		418,000.		1,267,000.
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more		1,560,000.		1,460,000.
21 Other liabilities (att. sch.) Stmt 8		2,000.		7,000.
22 Capital stock: a Preferred stock				
b Common stock	300,000.	300,000.	300,000.	300,000.
23 Additional paid-in capital				
24 Retained earnings - Appropriated (attach schedule)				
25 Retained earnings - Unappropriated		3,935,000.		3,988,000.
26 Adjustments to shareholders' equity (attach schedule)				
27 Less cost of treasury stock		( )		( )
28 Total liabilities and shareholders' equity		8,412,000.		10,152,000.

Schedule M-1 Reconciliation of Income (Loss) per Books With Income per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more - see instructions

1 Net income (loss) per books	53,000.	7 Income recorded on books this year not included on this return (itemize): Tax-exempt interest $	
2 Federal income tax per books	11,000.		
3 Excess of capital losses over capital gains			
4 Income subject to tax not recorded on books this year (itemize): See Statement 9	258,000.	8 Deductions on this return not charged against book income this year (itemize): a Depreciation $ b Charitable contributions $ Stmt 10 10,000.	10,000.
5 Expenses recorded on books this year not deducted on this return (itemize): a Depreciation $ b Charitable contributions $ c Travel and entertainment $		9 Add lines 7 and 8	10,000.
6 Add lines 1 through 5	322,000.	10 Income (page 1, line 28) - line 6 less line 9	312,000.

Schedule M-2 Analysis of Unappropriated Retained Earnings per Books (Line 25, Schedule L)

1 Balance at beginning of year	3,935,000.	5 Distributions: a Cash	
2 Net income (loss) per books	53,000.	b Stock	
3 Other increases (itemize):		c Property	
		6 Other decreases (itemize):	
		7 Add lines 5 and 6	
4 Add lines 1, 2, and 3	3,988,000.	8 Balance at end of year (line 4 less line 7)	3,988,000.

Form **4626**
Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax - Corporations

▶ See separate instructions.

▶ Attach to the corporation's tax return.

OMB No. 1545-0175

2009

Name: Highway and Bridge Company

Employer identification number: 99-9999998

Part I Alternative Minimum Tax Computation

	Note: See the instructions to find out if the corporation is a small corporation exempt from the alternative minimum tax (AMT) under section 55(e).				
1	Taxable income or (loss) before net operating loss deduction			1	312,000.
2	**Adjustments and preferences:**				
a	Depreciation of post-1986 property			2a	
b	Amortization of certified pollution control facilities			2b	
c	Amortization of mining exploration and development costs			2c	
d	Amortization of circulation expenditures (personal holding companies only)			2d	
e	Adjusted gain or loss			2e	
f	Long-term contracts			2f	
g	Merchant marine capital construction funds			2g	
h	Section 833(b) deduction (Blue Cross, Blue Shield, and similar type organizations only)			2h	
i	Tax shelter farm activities (personal service corporations only)			2i	
j	Passive activities (closely held corporations and personal service corporations only)			2j	
k	Loss limitations			2k	
l	Depletion			2l	
m	Tax-exempt interest income from specified private activity bonds			2m	
n	Intangible drilling costs			2n	
o	Other adjustments and preferences			2o	
3	Pre-adjustment alternative minimum taxable income (AMTI). Combine lines 1 through 2o			3	312,000.
4	**Adjusted current earnings (ACE) adjustment:**				
a	ACE from line 10 of the ACE worksheet in the instructions	4a	312,000.		
b	Subtract line 3 from line 4a. If line 3 exceeds line 4a, enter the difference as a negative amount (see instructions)	4b	0.		
c	Multiply line 4b by 75% (.75). Enter the result as a positive amount	4c			
d	Enter the excess, if any, of the corporation's total increases in AMTI from prior year ACE adjustments over its total reductions in AMTI from prior year ACE adjustments (see instructions). **Note:** You **must** enter an amount on line 4d (even if line 4b is positive)	4d			
e	ACE adjustment. • If line 4b is zero or more, enter the amount from line 4c • If line 4b is less than zero, enter the **smaller** of line 4c or line 4d as a negative amount			4e	0.
5	Combine lines 3 and 4e. If zero or less, stop here; the corporation does not owe any AMT			5	312,000.
6	Alternative tax net operating loss deduction (see instructions)			6	
7	**Alternative minimum taxable income.** Subtract line 6 from line 5. If the corporation held a residual interest in a REMIC, see instructions			7	312,000.
8	**Exemption phase-out** (if line 7 is $310,000 or more, skip lines 8a and 8b and enter -0- on line 8c):				
a	Subtract $150,000 from line 7 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-	8a			
b	Multiply line 8a by 25% (.25)	8b			
c	Exemption. Subtract line 8b from $40,000 (if completing this line for a member of a controlled group, see instructions). If zero or less, enter -0-			8c	0.
9	Subtract line 8c from line 7. If zero or less, enter -0-			9	312,000.
10	If the corporation had qualified timber gain, complete Part II and enter the amount from line 24 here. Otherwise, multiply line 9 by 20% (.20)			10	62,400.
11	Alternative minimum tax foreign tax credit (AMTFTC) (see instructions)			11	
12	Tentative minimum tax. Subtract line 11 from line 10			12	62,400.
13	Regular tax liability before applying all credits except the foreign tax credit			13	104,930.
14	**Alternative minimum tax.** Subtract line 13 from line 12. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return			14	0.

JWA **For Paperwork Reduction Act Notice, see the instructions.**

Form **4626** (2009)

917001
01-27-10

6

Highway and Bridge Company 99-9999998

Form 4626 (2009) Page 2

Part II Alternative Tax for Corporations with Qualified Timber Gain. Complete Part II **only** if the corporation had qualified timber gain under section 1201(b). See instructions.

15	Enter qualified timber gain from Schedule D (Form 1120), line 15, as refigured for the AMT, if necessary. If you are filing Form 1120-RIC, see instructions for the amount to enter	**15**	
16	Enter the amount from Schedule D (Form 1120), line 13, as refigured for the AMT, if necessary	**16**	
17	Enter the amount from Part I, line 9	**17**	
18	Enter the **smallest** of the amount on line 15, line 16, or line 17	**18**	
19	Multiply line 18 by 15% (.15)	**19**	
20	Subtract line 18 from line 17	**20**	
21	Multiply line 20 by 20% (.20)	**21**	
22	Enter the total of line 19 and line 21	**22**	
23	Multiply line 17 by 20% (.20)	**23**	
24	Enter the **smaller** of line 22 or line 23 here and on Part I, line 10	**24**	

Form **4626** (2009)

917002
01-27-10 JWA

Highway and Bridge Company 99-9999998

Adjusted Current Earnings (ACE) Worksheet

▶ See ACE Worksheet Instructions.

1	Pre-adjustment AMTI. Enter the amount from line 3 of Form 4626				1	312,000.
2	ACE depreciation adjustment:					
a	AMT depreciation			2a		
b	ACE depreciation:					
	(1) Post-1993 property	2b(1)				
	(2) Post-1989, pre-1994 property	2b(2)				
	(3) Pre-1990 MACRS property	2b(3)				
	(4) Pre-1990 original ACRS property	2b(4)				
	(5) Property described in sections 168(f)(1) through (4)	2b(5)				
	(6) Other property	2b(6)				
	(7) Total ACE depreciation. Add lines 2b(1) through 2b(6)			2b(7)		
c	ACE depreciation adjustment. Subtract line 2b(7) from line 2a				2c	
3	Inclusion in ACE of items included in earnings and profits (E&P):					
a	Tax-exempt interest income			3a		
b	Death benefits from life insurance contracts			3b		
c	All other distributions from life insurance contracts (including surrenders)			3c		
d	Inside buildup of undistributed income in life insurance contracts			3d		
e	Other items (see Regulations sections 1.56(g)-1(c)(6)(iii) through (ix) for a partial list)			3e		
f	Total increase to ACE from inclusion in ACE of items included in E&P. Add lines 3a through 3e				3f	
4	Disallowance of items not deductible from E&P:					
a	Certain dividends received			4a		
b	Dividends paid on certain preferred stock of public utilities that are deductible under section 247			4b		
c	Dividends paid to an ESOP that are deductible under section 404(k)			4c		
d	Nonpatronage dividends that are paid and deductible under section 1382(c)			4d		
e	Other items (see Regulations sections 1.56(g)-1(d)(3)(i) and (ii) for a partial list)			4e		
f	Total increase to ACE because of disallowance of items not deductible from E&P. Add lines 4a through 4e				4f	
5	Other adjustments based on rules for figuring E&P:					
a	Intangible drilling costs			5a		
b	Circulation expenditures			5b		
c	Organizational expenditures			5c		
d	LIFO inventory adjustments			5d		
e	Installment sales			5e		
f	Total other E&P adjustments. Combine lines 5a through 5e				5f	
6	Disallowance of loss on exchange of debt pools				6	
7	Acquisition expenses of life insurance companies for qualified foreign contracts				7	
8	Depletion				8	
9	Basis adjustments in determining gain or loss from sale or exchange of pre-1994 property				9	
10	**Adjusted current earnings.** Combine lines 1, 2c, 3f, 4f, and 5f through 9. Enter the result here and on line 4a of Form 4626				10	312,000.

917021
04-24-09

SCHEDULE B (Form 1120)

(Rev. December 2009)
Department of the Treasury
Internal Revenue Service

Additional Information for Schedule M-3 Filers

▶ Attach to Form 1120.
▶ See instructions on page 2.

OMB No. 1545-0123

Name	Employer identification number (EIN)
Highway and Bridge Company	99-9999998

		Yes	No
1	Do the amounts reported on Schedule M-3 (Form 1120), Part II, lines 9 or 10, column (d), reflect allocations to this corporation from a partnership of income, gain, loss, deduction, or credit that are disproportionate to this corporation's capital contribution to the partnership or its ratio for sharing other items of the partnership?		X
2	At any time during the tax year, did the corporation sell, exchange, or transfer any interest in an intangible asset to a related person as defined in section 267(b)?		X
3	At any time during the tax year, did the corporation acquire any interest in an intangible asset from a related person as defined in section 267(b)?		X
4a	During the tax year, did the corporation enter into a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations?		X
b	At any time during the tax year, was the corporation a participant in a cost-sharing arrangement with any related foreign party on whose behalf the corporation did not file Form 5471?		X
5	At any time during the tax year, did the corporation make any change in accounting principle for financial accounting purposes? See instructions for the definition of change in accounting principle		X
6	At any time during the tax year, did the corporation make any change in a method of accounting for U.S. income tax purposes?		X
7	At any time during the tax year, did the corporation own any voluntary employees' beneficiary association (VEBA) trusts that were used to hold funds designated for employee benefits?		X
8	At any time during the tax year, did the corporation use an allocation method for indirect costs capitalized to self-constructed assets that varied from its financial method of accounting?		X
9	At any time during the tax year, did the corporation treat for tax purposes indirect costs, as defined in Regulations sections 1.263A-1(e)(3)(ii)(F), (G), and (H), as mixed-service costs, as defined in Regulations section 1.263A-1(e)(4)(ii)(C)?		X
10	Did the corporation, under section 118 or 362(c) and the related regulations, take a return filing position characterizing any amount as a contribution to the capital of the corporation during the tax year by any non-shareholders? Amounts so characterized may include, without limitation, incentives, inducements, money, and property		X

For Paperwork Reduction Act Notice, see the Instructions for Form 1120. **Schedule B (Form 1120) (Rev. 12-2009)**

913731 01-14-10 JWA

SCHEDULE M-3 (Form 1120)

Department of the Treasury
Internal Revenue Service

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More

▶ Attach to Form 1120 or 1120-C.
▶ See separate instructions.

OMB No. 1545-0123

2009

Name of corporation (common parent, if consolidated return)

Highway and Bridge Company

Employer identification number

99-9999998

Check applicable box(es): (1) ☐ Non-consolidated return (2) ☐ Consolidated return (Form 1120 only)
(3) ☐ Mixed 1120/L/PC group (4) ☐ Dormant subsidiaries schedule attached

Part I Financial Information and Net Income (Loss) Reconciliation (see instructions)

1 a Did the corporation file SEC Form 10-K for its income statement period ending with or within this tax year?
☐ **Yes.** Skip lines 1b and 1c and complete lines 2a through 11 with respect to that SEC Form 10-K.
☒ **No.** Go to line 1b. See instructions if multiple non-tax-basis income statements are prepared.

b Did the corporation prepare a certified audited non-tax-basis income statement for that period?
☐ **Yes.** Skip line 1c and complete lines 2a through 11 with respect to that income statement.
☒ **No.** Go to line 1c.

c Did the corporation prepare a non-tax-basis income statement for that period?
☒ **Yes.** Complete lines 2a through 11 with respect to that income statement.
☐ **No.** Skip lines 2a through 3c and enter the corporation's net income (loss) per its books and records on line 4a.

2 a Enter the income statement period: Beginning 01/01/2009 Ending 12/31/2009

b Has the corporation's income statement been restated for the income statement period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☒ **No.**

c Has the corporation's income statement been restated for any of the five income statement periods preceding the period on line 2a?
☐ **Yes.** (If "Yes," attach an explanation and the amount of each item restated.)
☒ **No.**

3 a Is any of the corporation's voting common stock publicly traded?
☐ **Yes.**
☒ **No.** If "No," go to line 4a.

b Enter the symbol of the corporation's primary U.S. publicly traded voting common stock .....

c Enter the nine-digit CUSIP number of the corporation's primary publicly traded voting common stock .....

4 a	Worldwide consolidated net income (loss) from income statement source identified in Part I, line 1	4a	53,000.
b	Indicate accounting standard used for line 4a (see instructions): (1) ☒ GAAP (2) ☐ IFRS (3) ☐ Statutory (4) ☐ Tax-basis (5) ☐ Other (specify)		
5 a	Net income from nonincludible foreign entities (attach schedule)	5a	( )
b	Net loss from nonincludible foreign entities (attach schedule and enter as a positive amount)	5b	
6 a	Net income from nonincludible U.S. entities (attach schedule)	6a	( )
b	Net loss from nonincludible U.S. entities (attach schedule and enter as a positive amount)	6b	
7 a	Net income (loss) of other includible foreign disregarded entities (attach schedule)	7a	
b	Net income (loss) of other includible U.S. disregarded entities (attach schedule)	7b	
c	Net income (loss) of other includible entities (attach schedule)	7c	
8	Adjustment to eliminations of transactions between includible entities and nonincludible entities (attach sch.)	8	
9	Adjustment to reconcile income statement period to tax year (attach schedule)	9	
10 a	Intercompany dividend adjustments to reconcile to line 11 (attach schedule)	10a	
b	Other statutory accounting adjustments to reconcile to line 11 (attach schedule)	10b	
c	Other adjustments to reconcile to amount on line 11 (attach schedule)	10c	
11	**Net income (loss) per income statement of includible corporations.** Combine lines 4 through 10	11	53,000.

Note. Part I, line 11, must equal the amount on Part II, line 30, column (a), and Schedule M-2, line 2.

12 Enter the total amount (not just the corporation's share) of the assets and liabilities of all entities included or removed on the following lines.

		Total Assets	Total Liabilities
a	Included on Part I, line 4 ▶		
b	Removed on Part I, line 5 ▶		
c	Removed on Part I, line 6 ▶		
d	Included on Part I, line 7 ▶		

JWA **For Paperwork Reduction Act Notice, see the Instructions for Form 1120.** **Schedule M-3 (Form 1120) 2009**

913321 / 01-14-10

10

Schedule M-3 (Form 1120) 2009 Page 2

Name of corporation (common parent, if consolidated return) | Employer identification number

Highway and Bridge Company | 99-9999998

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | Employer identification number

Part II Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return (see instructions)

Income (Loss) Items (Attach schedules for lines 1 through 11)	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1 Income (loss) from equity method foreign corporations				
2 Gross foreign dividends not previously taxed				
3 Subpart F, QEF, and similar inc inclusions				
4 Section 78 gross-up				
5 Gross foreign distributions previously taxed				
6 Income (loss) from equity method U.S. corporations				
7 U.S. dividends not eliminated in tax consolidation				
8 Minority interest for includible corporations				
9 Income (loss) from U.S. partnerships				
10 Income (loss) from foreign partnerships				
11 Income (loss) from other pass-through entities				
12 Items relating to reportable transactions (attach details)				
13 Interest income (attach Form 8916-A)				
14 Total accrual to cash adjustment				
15 Hedging transactions				
16 Mark-to-market income (loss)				
17 Cost of goods sold (attach Form 8916-A)	( )			( )
18 Sale versus lease (for sellers and/or lessors)				
19 Section 481(a) adjustments				
20 Unearned/deferred revenue				
21 Income recognition from long-term contracts	2,239,000.	258,000.		2,497,000.
22 Original issue discount and other imputed interest				
23a Income statement gain/loss on sale, exchange, abandonment, worthlessness, or other disposition of assets other than inventory and pass-through entities				
b Gross capital gains from Schedule D, excluding amounts from pass-through entities				
c Gross capital losses from Schedule D, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
d Net gain/loss reported on Form 4797, line 17, excluding amounts from pass-through entities, abandonment losses, and worthless stock losses				
e Abandonment losses				
f Worthless stock losses (attach details)				
g Other gain/loss on disposition of assets other than inventory				
24 Capital loss limitation and carryforward used				
25 Other income (loss) items with differences (attach sch)				
26 **Total income (loss) items.** Combine lines 1 through 25	2,239,000.	258,000.		2,497,000.
27 **Total expense/deduction items** (from Part III, line 36)	<2,171,000.>		1,000.	<2,170,000.>
28 Other items with no differences	<15,000.>			<15,000.>
29a Mixed groups, see instructions. All others, combine lines 26 through 28	53,000.	258,000.	1,000.	312,000.
b PC insurance subgroup reconciliation totals				
c Life insurance subgroup reconciliation totals				
30 **Reconciliation totals.** Combine lines 29a through 29c	53,000.	258,000.	1,000.	312,000.

Note. Line 30, column (a), must equal the amount on Part I, line 11, and column (d) must equal Form 1120, page 1, line 28.

JWA Schedule M-3 (Form 1120) 2009

913322
01-14-10

11

Schedule M-3 (Form 1120) 2009 Page 3

Name of corporation (common parent, if consolidated return) | Employer identification number

Highway and Bridge Company | 99-9999998

Check applicable box(es): (1) ☐ Consolidated group (2) ☐ Parent corp (3) ☐ Consolidated eliminations (4) ☐ Subsidiary corp (5) ☐ Mixed 1120/L/PC group

Check if a sub-consolidated: (6) ☐ 1120 group (7) ☐ 1120 eliminations

Name of subsidiary (if consolidated return) | Employer identification number

Part III Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return - Expense/Deduction Items (see instructions)

Expense/Deduction Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 U.S. current income tax expense	11,000.		<11,000.>	
2 U.S. deferred income tax expense				
3 State and local current income tax expense				
4 State and local deferred income tax expense				
5 Foreign current income tax expense (other than foreign withholding taxes)				
6 Foreign deferred income tax expense				
7 Foreign withholding taxes				
8 Interest expense (attach Form 8916-A)				
9 Stock option expense				
10 Other equity-based compensation				
11 Meals and entertainment				
12 Fines and penalties				
13 Judgments, damages, awards, and similar costs				
14 Parachute payments				
15 Compensation with section 162(m) limitation Stmt 12	1,850,000.			1,850,000.
16 Pension and profit-sharing	240,000.			240,000.
17 Other post-retirement benefits				
18 Deferred compensation				
19 Charitable contribution of cash and tangible property				
20 Charitable contribution of intangible property				
21 Charitable contribution limitation/carryforward				
22 Domestic production activities deduction			10,000.	10,000.
23 Current year acquisition or reorganization investment banking fees				
24 Current year acquisition or reorganization legal and accounting fees				
25 Current year acquisition/ reorganization other costs				
26 Amortization/impairment of goodwill				
27 Amortization of acquisition, reorganization, and start-up costs				
28 Other amortization or impairment write-offs				
29 Section 198 environmental remediation costs				
30 Depletion				
31 Depreciation	70,000.			70,000.
32 Bad debt expense				
33 Corporate owned life insurance premiums				
34 Purchase versus lease (for purchasers and/or lessees)				
35 Other expense/deduction items with differences (attach schedule)				
36 **Total expense/deduction items.** Combine lines 1 through 35. Enter here and on Part II, line 27, reporting positive amounts as negative and negative amounts as positive	2,171,000.		<1,000.>	2,170,000.

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01-14-10

Schedule M-3 (Form 1120) 2009

12

Form **8916-A**

Department of the Treasury
Internal Revenue Service

Supplemental Attachment to Schedule M-3

▶ Attach to Schedule M-3 for Form 1065, 1120, 1120-L, 1120-PC, or 1120S.

OMB No. 1545-2061

2009

Name of common parent: Highway and Bridge Company

Employer identification number: 99-9999998

Name of subsidiary:

Employer identification number:

Part I Cost of Goods Sold

Cost of Goods Sold Items	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1 Amounts attributable to cost flow assumptions				
2 Amounts attributable to:				
a Stock option expense				
b Other equity based compensation				
c Meals and entertainment				
d Parachute payments				
e Compensation with section 162(m) limitation				
f Pension and profit sharing				
g Other post-retirement benefits				
h Deferred compensation				
i Section 198 environmental remediation costs				
j Amortization				
k Depletion				
l Depreciation				
m Corporate owned life insurance premiums				
See Statement 13 n Other section 263A costs	1,925,000.			1,925,000.
3 Inventory shrinkage accruals				
4 Excess inventory and obsolescence reserves				
5 Lower of cost or market write-downs				
6 Other items with differences (attach schedule)				
See Statement 14 7 Other items with no differences	20,250,000.			20,250,000.
8 **Total cost of goods sold.** Add lines 1 through 7, in columns a, b, c, and d	22,175,000.			22,175,000.

JWA **For Paperwork Reduction Act Notice, see page 4.** Form **8916-A** (2009)

913315
01-27-10

13

Form 8916-A (2009) Highway and Bridge Company 99-9999998 Page 2

Part II Interest Income

	Interest Income Item	(a) Income (Loss) per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Income (Loss) per Tax Return
1	Tax-exempt interest income				
2	Interest income from hybrid securities				
3	Sale/lease interest income				
4a	Intercompany interest income - From outside tax affiliated group				
4b	Intercompany interest income - From tax affiliated group				
5	Other interest income				
6	Total interest income. Add lines 1 through 5. Enter total on Schedule M-3 (Forms 1120, 1120-PC, and 1120-L), Part II, line 13 or Schedule M-3 (Forms 1065 and 1120S) Part II, line 11.				

Part III Interest Expense

	Interest Expense Item	(a) Expense per Income Statement	(b) Temporary Difference	(c) Permanent Difference	(d) Deduction per Tax Return
1	Interest expense from hybrid securities				
2	Lease/purchase interest expense				
3a	Intercompany interest expense - Paid to outside tax affiliated group				
3b	Intercompany interest expense - Paid to tax affiliated group				
4	Other interest expense				
5	Total interest expense. Add lines 1 through 4. Enter total on Schedule M-3 (Form 1120) Part III, line 8; Schedule M-3 (Forms 1120-PC and 1120-L), Part III, line 36; Schedule M-3 (Form 1065) Part III, line 27; or Schedule M-3 (Form 1120S) Part III, line 26.				

JWA Form **8916-A** (2009)

913316
02-01-10

14

Highway and Bridge Company 99-9999998

Footnotes Statement 1

Taxpayer's normal method of accounting for long-term constructions contracts is the completed contract method. As required by IRC Section 460, the taxpayer reports contract income on the percentage-of-completion method for all long-term contracts entered into after July 10, 1989.

15 Statement(s) 1

Highway and Bridge Company 99-9999998

Form 1120	Other Deductions	Statement 2

Description	Amount
Insurance	180,000.
Utilities	60,000.
Travel	196,000.
Legal and accounting	30,000.
Vehicle expenses	560,000.
Meals and entertainment	4,000.
Miscellaneous	430,000.
Allocated to contract costs	<1,925,000.>
Total to Form 1120, Line 26	<465,000.>

Schedule A	Additional Section 263A Costs	Statement 3

Description	Amount
Indirect costs allocated to contracts	1,925,000.
Total to Schedule A, line 4	1,925,000.

Schedule A	Cost of Goods Sold - Other Costs	Statement 4

Description	Amount
Materials	7,048,000.
Subcontractors	8,050,000.
Job site wages and salaries	3,030,000.
Supplies and tools	190,000.
Gasoline, fuel, and grease	500,000.
Bonds and permits	150,000.
Equipment rental	420,000.
Job site utilities	70,000.
Production period interest	180,000.
Depreciation	630,000.
Total to Schedule A, Line 5	20,268,000.

Highway and Bridge Company 99-9999998

Tax Computation Statement 5

1.	Taxable Income	312,000	
2.	Lesser of Line 1 or First Bracket Amount	50,000	
3.	Line 1 Less Line 2	262,000	
4.	Lesser of Line 3 or Second Bracket Amount	25,000	
5.	Line 3 Less Line 4	237,000	
6.	Income Subject to 34% Tax Rate	237,000	
7.	Income Subject to 35% Tax Rate	0	
8.	15 Percent of Line 2	7,500	
9.	25 Percent of Line 4	6,250	
10.	34 Percent of Line 6	80,580	
11.	35 Percent of Line 7	0	
12.	Additional 5% Surtax.	10,600	
13.	Additional 3% Surtax	0	
14.	Total Income Tax		104,930

Highway and Bridge Company 99-9999998

Schedule L Other Current Assets Statement 6

Description	Beginning of Tax Year	End of Tax Year
Costs and estimated earnings in excess of billings on uncompleted contracts	640,000.	611,000.
Prepaid expenses	20,000.	30,000.
Recoverable federal income taxes	10,000.	35,000.
Deferred income taxes	42,000.	146,000.
Total to Schedule L, Line 6	712,000.	822,000.

Schedule L Other Current Liabilities Statement 7

Description	Beginning of Tax Year	End of Tax Year
Billings in excess of costs and estimated earnings on uncompleted contracts	202,000.	699,000.
Accrued liabilities	216,000.	568,000.
Total to Schedule L, Line 18	418,000.	1,267,000.

Schedule L Other Liabilities Statement 8

Description	Beginning of Tax Year	End of Tax Year
Deferred income taxes	2,000.	7,000.
Total to Schedule L, Line 21	2,000.	7,000.

Schedule M-1 Taxable Income not Recorded on Books Statement 9

Description	Amount
Income Recognition from Long-Term Contracts	258,000.
Total to Schedule M-1, Line 4	258,000.

18 Statement(s) 6, 7, 8, 9

Highway and Bridge Company 99-9999998

Schedule M-1 Other Deductions in this Return not Charged Against Book Income Statement 10

Description	Amount
Domestic Production Activity Deduction	10,000.
Total to Schedule M-1, Line 8	10,000.

Schedule M-3 Other Expense/Deduction Items with No Differences Statement 11

Description	Expense/ Deduction per Income Statement	Expense/ Deduction per Tax Return
Allocated to contract costs	<1925000.>	<1925000.>
Insurance	180,000.	180,000.
Legal and accounting	30,000.	30,000.
Meals and entertainment	4,000.	4,000.
Miscellaneous	430,000.	430,000.
Other Taxes	480,000.	480,000.
Travel	196,000.	196,000.
Utilities	60,000.	60,000.
Vehicle expenses	560,000.	560,000.
Total to Schedule M-3, Part II, Line 28	15,000.	15,000.

Schedule M-3 Compensation with Sec. 162(m) Limitation Statement 12

Description	Expense per Income Statement	Temporary Difference	Permanent Difference	Deduction per Tax Return
Officers Compensation	100,000.		0.	100,000.
Salaries and Wages	1,750,000.		0.	1,750,000.
Total	1,850,000.		0.	1,850,000.

19 Statement(s) 10, 11, 12

Highway and Bridge Company 99-9999998

Form 8916-A Other section 263A costs Statement 13

Description	per Income Statement	Temporary Difference	Permanent Difference	per Tax Return
Indirect costs allocated to contracts	1,925,000.	0.	0.	1,925,000.
Total to Line 2n	1,925,000.	0.	0.	1,925,000.

Form 8916-A Other Items with No Differences Statement 14

Description	per Income Statement	per Tax Return
Beginning Inventory	22,000.	22,000.
Bonds and permits	150,000.	150,000.
Depreciation	630,000.	630,000.
Ending Inventory	<40,000.>	<40,000.>
Equipment rental	420,000.	420,000.
Gasoline, fuel, and grease	500,000.	500,000.
Job site utilities	70,000.	70,000.
Job site wages and salaries	3,030,000.	3,030,000.
Materials	7,048,000.	7,048,000.
Production period interest	180,000.	180,000.
Subcontractors	8,050,000.	8,050,000.
Supplies and tools	190,000.	190,000.
Total to Line 7	20250000.	20250000.

Highway and Bridge Company 99-9999998

Form 8916-A Other section 263A costs Statement 13

Description	per Income Statement	Temporary Difference	Permanent Difference	per Tax Return
Indirect costs allocated to contracts	1,925,000.	0.	0.	1,925,000.
Total to Line 2n	1,925,000.	0.	0.	1,925,000.

Form 8916-A Other Items with No Differences Statement 14

Description	per Income Statement	per Tax Return
Beginning Inventory	22,000.	22,000.
Bonds and permits	150,000.	150,000.
Depreciation	630,000.	630,000.
Ending Inventory	<40,000.>	<40,000.>
Equipment rental	420,000.	420,000.
Gasoline, fuel, and grease	500,000.	500,000.
Job site utilities	70,000.	70,000.
Job site wages and salaries	3,030,000.	3,030,000.
Materials	7,048,000.	7,048,000.
Production period interest	180,000.	180,000.
Subcontractors	8,050,000.	8,050,000.
Supplies and tools	190,000.	190,000.
Total to Line 7	20250000.	20250000.

Statement 1—Form 1120
Highway and Bridge Company
99-9999999
December 31, 20X2

Line 26—Other deductions

Insurance	$ 180,000
Utilities	60,000
Travel	196,000
Legal and accounting	30,000
Vehicle expenses	560,000
Meals and entertainment	4,000
Miscellaneous	430,000
Allocated to contract costs	(1,925,000)
Total	$ (465,000)

Schedule A; Line 4

Indirect costs allocated to contracts	$ 1,925,000

Schedule A; Line 5

Materials	$ 7,048,000
Subcontractors	8,050,000
Job site wages and salaries	3,030,000
Supplies and tools	190,000
Gasoline, fuel, and grease	500,000
Bonds and permits	150,000
Equipment rental	420,000
Job site utilities	70,000
Production period interest	180,000
Depreciation	630,000
Total other costs	$ 20,268,000

Statement 2—Form 1120
Highway and Bridge Company
99-9999999
December 31, 20X2

Form 1120; Schedule K; Line 1.c.

Taxpayer's normal method of accounting for long-term construction contracts is the completed-contract method. As required by IRC Section 460, the taxpayer reports contract income on the percentage-of-completion method for all long-term contracts entered into after July 10, 1989.

Form 1120; Schedule L

	Beginning of Tax Year	End of Tax Year
Line 6—Other current assets:		
Costs and estimated earnings in excess of billings on uncompleted contracts	$ 640,000	$ 611,000
Prepaid expenses	20,000	30,000
Recoverable Federal income taxes	10,000	35,000
Deferred income taxes	42,000	146,000
	$ 712,000	$ 822,000
Line 18—Other current liabilities:		
Billings in excess of costs and estimated earnings on uncompleted contracts	$ 202,000	$ 699,000
Accrued liabilities	216,000	568,000
	$ 418,000	$ 1,267,000
Line 21—Other liabilities:		
Deferred income taxes	$ 2,000	$ 7,000

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. For taxpayers that owe look-back interest to the government which of the following procedures should be performed?

    a. Form 8697 should be completed and attached to the taxpayers' income tax return.

    b. Form 8697 should be filed separately from the taxpayers' income tax return.

    c. Form 8697 should be signed by the taxpayer and the preparer.

    d. Form 8697 should be completed and the contract schedules should not be attached to the return.

16. Blarney Construction Company had $4,680 of refundable interest related to the application of the look-back requirement. What should the interest be shown as on Blarney Construction Co.'s federal income tax return?

    a. Interest income.

    b. Personal interest.

    c. Interest expense.

    d. Other income.

17. Which of the following types of transactions relating to mid-contract changes require the new taxpayer to apply the look-back method for all transactions at the time the contract is complete?

    a. Pre-transactions.

    b. Post-transactions.

    c. Step-in-the-shoes transactions.

    d. Constructive completion transaction.

18. When a corporation is filing Form 1120, which of the following is included in total income?

    a. Advertising.

    b. Gross royalties.

    c. Taxes and licenses.

    d. Repairs and maintenance.

19. Busy Builders has $360,000 reported on line 21 of Form 1120 under deductions, what does this amount represent?

    a. Rents.

    b. Interest.

    c. Bad Debts.

    d. Depletion.

20. Which of the following is information that would be included in Schedule K of Form 1120?

    a. How much inventory a corporation has at the end of the year.

    b. Whether or not the corporation has any foreign tax credit.

    c. What type of accounting method the corporation uses.

    d. What type of taxes from Form 8611 a corporation has.

21. Grey Co. is currently filling out Form 1120. The CPA knows that the income per books will be reconciled with the income per return. What schedule would be used to accomplish this task?

    a. Schedule L.

    b. Schedule J.

    c. Schedule M-1.

    d. Schedule M-2.

22. Which of the following would be found in Part I of Schedule M-3 of Form 1120?

    a. Cost of goods sold.

    b. Bad debt expense.

    c. U.S. deferred income tax expense.

    d. Worldwide consolidated net income.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

15. For taxpayers that owe look-back interest to the government which of the following procedures should be performed? **(Page 144)**

    a. Form 8697 should be completed and attached to the taxpayers' income tax return. [This answer is correct. For taxpayers that owe look-back interest to the government, Form 8697 is completed and attached to their income tax return. The calculated look-back interest due is shown as additional tax and included in the total tax liability.]

    b. Form 8697 should be filed separately from the taxpayers' income tax return. [This answer is incorrect. If look-back interest is owed to the taxpayer by the government, Form 8697 is filed separately from the income tax return.]

    c. Form 8697 should be signed by the taxpayer and the preparer. [This answer is incorrect. A Form 8697 filed with a taxpayer's return is not required to be signed when a taxpayer owes look-back interest to the government.]

    d. Form 8697 should be completed and the contract schedules should not be attached to the return. [This answer is incorrect. Form 8697 should be completed when a taxpayer owes look-back interest, however contract schedules must be attached. Taxpayers not attaching contract schedules to Form 8697 is a common error related to look-back issues.]

16. Blarney Construction Company had $4,680 of refundable interest related to the application of the look-back requirement. What should the interest be shown as on Blarney Construction Co.'s federal income tax return? **(Page 145)**

    a. Interest income. [This answer is correct. The amount reported as refundable interest on Form 8697 must be shown as interest income on the taxpayer's federal income tax return for the tax year in which it is accrued or received.]

    b. Personal interest. [This answer is incorrect. Blarney Construction Company is not an individual taxpayer for whom Reg. 1.460-6(f) states that look-back interest is treated as personal interest.]

    c. Interest expense. [This answer is incorrect. Had Blarney Construction owed interest, the amount of any interest payable on Form 8697 is deductible in the year accrued or paid, subject to any applicable limitations under IRC Sec. 163.]

    d. Other income. [This answer is incorrect. The $4,680 in interest refunded to Blarney Construction Co. would not be considered other income on the taxpayer's federal income tax return per IRS regulations.]

17. Which of the following types of transactions relating to mid-contract changes require the new taxpayer to apply the look-back method for all transactions at the time the contract is complete? **(Page 146)**

    a. Pre-transactions. [This answer is incorrect. This is not a type of change. Pre-transactions can have look-back calculations performed by either the new taxpayer or old taxpayer depending on the situation.]

    b. Post-transactions. [This answer is incorrect. This is not a type of change. The new taxpayer is required to apply look-back procedures on all post-transactions.]

    c. Step-in-the-shoes transactions. [This answer is correct. When involved in step-in-the-shoes transactions the look-back method is applied only by the new taxpayer at the time the contract is complete. The new taxpayer must account for both the pre-transaction and post-transaction look-back interest.]

    d. Constructive completion transaction. [This answer is incorrect. In constructive completion transaction, the old taxpayer must take into account all pre-transaction look-back computations at the time of the

transaction and the new taxpayer must take into account any post-transaction look-back computations in the year the contract is completed.]

18. When a corporation is filing Form 1120, which of the following is included in total income? **(Page 148)**

    a. Advertising. [This answer is incorrect. Advertising costs represent a deduction taxpayers can take to reduce taxable income.]

    b. Gross royalties. [This answer is correct. Gross royalties represent a line item included in total income when filing Form 1120.]

    c. Taxes and licenses. [This answer is incorrect. Amounts paid for taxes and licenses would be included as a deduction on Form 1120 to reduce a taxpayer's taxable income.]

    d. Repairs and maintenance. [This answer is incorrect. Repairs and maintenance costs would be reported as a deduction on line 14 of Form 1120.]

19. Busy Builders has $360,000 reported on line 21 of Form 1120 under deductions, what does this amount represent? **(Page 148)**

    a. Rents. [This answer is incorrect. Rents is a line item under the deductions section of Form 1120, however they appear on line 16. Types of rent that may appear on this line include building and equipment rent.]

    b. Interest. [This answer is incorrect. Interest amounts paid are recorded on line 18 of Form 1120 under the deductions section. Remember, interest expense on an under-payment of tax is deductible for corporations but not for individuals.]

    c. Bad Debts. [This answer is incorrect. Bad debt amounts appear on line 15 of Form 1120. Bad debt expense is allowed to be deducted only when incurred. Allowance for doubtful accounts is nondeductible.]

    d. Depletion. [This answer is correct. Amounts placed on line 21 of Form 1120 under the deductions section represent depletion. Depletion reflects the diminution of a taxpayer's interest in exhaustible natural resources.]

20. Which of the following is information that would be included in Schedule K of Form 1120? **(Page 148)**

    a. How much inventory a corporation has at the end of the year. [This answer is incorrect. The amount of inventory a company has at the end of the year is recorded on Schedule A of Form 1120.]

    b. Whether or not the corporation has any foreign tax credit. [This answer is incorrect. Foreign tax credit appears on line 6a of Schedule J of Form 1120.]

    c. What type of accounting method the corporation uses. [This answer is correct. A company must state what type of accounting method they used, cash, accrual, or other. If the other option is chosen a company must specify.]

    d. What type of taxes from Form 8611 a corporation has. [This answer is incorrect. A company will record taxes from Forms 4255, 8611, 8697, 8866, 8902 on line 10 of Schedule J of Form 1120.]

21. Grey Co. is currently filling out Form 1120. The CPA knows that the income per books will be reconciled with the income per return. What schedule would be used to accomplish this task? **(Page 148)**

    a. Schedule L. [This answer is incorrect. A company records the balance sheet per books on Schedule L.]

    b. Schedule J. [This answer is incorrect. If the CPA were to complete Schedule J of Form 1120, they would be performing the tax computation, in order to determine the total tax due.]

    c. Schedule M-1. [This answer is correct. Reconciliation of income per the company's books with income per the return is performed on Schedule M-1.]

    d. Schedule M-2. [This answer is incorrect. Schedule M-2 involves an analysis of unappropriated retained earnings per a company's books.]

22. Which of the following would be found in Part I of Schedule M-3 of Form 1120? **(Page 148)**

    a. Cost of goods sold. [This answer is incorrect. Cost of goods sold would be recorded on line 17 in Part II of Schedule M-3.]

    b. Bad debt expense. [This answer is incorrect. If a taxpayer had incurred bad debt expense, they would be eligible to include it in Part III of Schedule M-3 of Form 1120.]

    c. U.S. deferred income tax expense. [This answer is incorrect. U.S. deferred income tax expense would be recorded on line 2 in Part III of Schedule M-3.]

    d. Worldwide consolidated net income. [This answer is correct. Worldwide consolidated net income is recorded on line 4 in Part I of Schedule M-3.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (CONTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Margaret owns a construction company that had taxable income of $15,425,000 for 20X4. Compute the regular tax for Margaret's C corporation construction company.

   a. $5,244,500.

   b. $5,311,500.

   c. $5,398,750.

   d. $5,861,500.

2. Calvin Construction Co., a C corporation, had $80,000 of taxable income at December 31, 20X2. Compute Calvin Construction's regular tax liability for 20X2.

   a. $12,000.

   b. $15,000.

   c. $15,450.

   d. $27,200.

3. Which of the following taxpayers properly followed the alternative minimum tax (AMT) rules introduced by the Taxpayer Relief Act of 1986?

Taxpayer	Regular Tax	TMT	Company's tax liability
Buildings, Inc.	$ 40,000	$ 50,000	$ 40,000
Doors, Inc.	150,000	75,000	75,000
Apartments, Inc	210,000	250,000	250,000
Roofs, Inc.	85,000	100,000	85,000

   a. Buildings, Inc.

   b. Doors, Inc.

   c. Apartments, Inc.

   d. Roofs, Inc.

4. The 1997 Taxpayer Relief Act exempts small corporations from AMT. A small corporation is one that, for its first tax year beginning after 1996, has average annual gross receipts of less than what amount for the three prior tax years?

   a. $2 million.

   b. $5 million.

   c. $7.5 million.

   d. $10 million.

5. Select the taxpayer that would have to calculate adjusted current earnings (ACE) depreciation on their assets.

   a. Corporation 1: Assets placed in service on February 11, 1991.

   b. Corporation 2: Assets placed in service on March 2, 1994.

   c. Corporation 3: Assets placed in service on June 9, 1997.

   d. Corporation 4: Assets placed in service on November 20, 2000.

6. Pinway Construction computed a regular tax liability of $106,000 and tentative minimum tax (TMT) of $154,000 for 20X3. What amount will Pinway Construction record as their 20X3 taxes payable?

   a. $48,000.

   b. $106,000.

   c. $154,000.

   d. $260,000.

7. When a taxpayer applies the look-back requirement to prior taxable years in which a contract was in progress, they will recompute the gross profit based upon which of the following:

   a. The estimated total contract price and the estimated cost.

   b. The estimated total contract price and the actual cost.

   c. The actual total contract price and the estimated cost.

   d. The actual total contract price and the actual cost.

8. After performing the look-back calculation Greg Construction determined they owed interest. In the first quarter of the calendar year the interest rate was 12%, second quarter of the year 15%, third quarter of the year 20%, and the fourth quarter of the year 25%. The interest rate accrual date is July 22, 2003. Based on the information given what interest rate will apply to Greg Construction's interest accrual period?

   a. 12%.

   b. 15%.

   c. 20%.

   d. 25%.

9. The 1997 Taxpayer Relief Act provided a *de minimis* election. Which of the following is a rule related to this election?

   a. The gross price of the contract at completion cannot exceed $1 million.

   b. The contract must be completed within two years of the contract commencement date.

   c. Estimated income recognized in each year of the contract must be within 10% of the actual income for each contract year.

   d. The gross price of the contract at completion cannot exceed 1% of the average annual gross receipts of the taxpayer for the three years preceding the completion year.

10. Which of the following types of entities is **not** required to use the "Simplified Marginal Impact Method" (SMIM) for calculating look-back interest?

    a. Trust.

    b. S Corporation.

    c. C Corporation.

    d. Non-closely held partnership.

11. Jones Construction has the following information regarding one of their contracts.

Actual contract costs to date	$	515,000
Estimated contract costs	$	465,000
Total actual final contract costs	$	515,000
Total estimated contract costs	$	600,000
Final gross profit	$	265,000

    Based on the above facts, what would Jones Construction calculate as the actual gross profit to date?

    a. $205,375.

    b. $227,370.

    c. $239,295.

    d. $265,000.

12. Look-back interest due or refundable must be computed at the corporate overpayment rate determined under IRC Sec. 6621(a)(1) and is compounded how frequently from the due date of the return for the prior period to the due date of the return for the year the contract is completed?

    a. Daily.

    b. Weekly.

    c. Monthly.

    d. Quarterly.

Use the following information to answer questions 13–14.

Bright Construction has the following information related to 20X1 and 20X2.

Look-back Calculation Worksheet
December 31, 20X2

Taxable income of prior year	$	175,000
Look-back understatement of prior year		65,000
Adjusted look-back taxable income		240,000
Look-back regular tax using prior year rates		76,850
Look-back tentative minimum tax		44,500
20X1 look-back tax liability		
Income tax liability on previous return		51,500
Increase/Decrease in tax for the prior year on which interest is due or refundable		
Interest rate		6%
Look back time period		365 days
Interest payable or refund		

13. What amount should appear as Bright Construction's 20X1 look-back tax liability?

    a. $32,350.

    b. $44,500.

    c. $51,500.

    d. $76,850.

14. What amount will Bright owe or receive in interest based on the look-back calculation?

    a. Owe $420.

    b. Owe $1,521.

    c. Receive $420.

    d. Receive $1,521.

15. In August 2004, the Large and Mid-size Business Division (LMSB) of the IRS issued a memorandum to LMSB directors and managers providing information regarding noncompliance of look-back interest under IRC Sec. 460. Which of the following look-back errors was **not** included in the Alert?

    a. Incorrectly computing interest from a Net Operating Loss (NOL) carryback year instead of from the year generating the NOL.

    b. The interest accrual periods are not used when calculating look-back interest to be paid or refunded.

    c. Filing look-back under their FEIN instead of its parent's FEIN by members of a consolidated group.

    d. Instead of being applied at the owner level, Simplified Marginal Impact Method (SMIM) is being applied at the entity level for taxpayers electing SMIM.

16. C Corporations with total assets of $10 million or more are required to complete which of the following?

    a. Schedule M-1.

    b. Schedule M-3.

    c. Form 1120.

    d. Form 1065.

17. If U&I Construction had $675,000 in administrative salaries and wages, what line should this amount appear on their Form 1120?

    a. Line 12.

    b. Line 13.

    c. Line 17.

    d. Line 24.

18. Costs of Goods Sold is computed on which schedule of Form 1120?

    a. Schedule A.

    b. Schedule C.

    c. Schedule E.

    d. Schedule J.

19. According to Schedule C of Form 1120, what percent deduction can a company receive for dividends received from a less-than-20% owned domestic corporation?

    a. 70%.

    b. 80%.

    c. 85%.

    d. 100%.

20. If a corporation directly owns more than 50% of the voting stock of a domestic corporation all of the following information would be included in their return on Schedule K **except**:

    a. Country in which the corporation was incorporated.

    b. Name and employer identification number (EIN).

    c. The total voting power of all classes of stock of the corporation entitled to vote.

    d. Taxable income before NOL and special deductions of such corporation for the tax year ending with or within your tax year.

21. If a corporation's total receipts for the tax year and its total assets at the end of the tax year are less than $250,000, which of the following schedules will the corporation still need to complete?

    a. Schedule L.

    b. Schedule A.

    c. Schedule M-1.

    d. Schedule M-2.

22. Select the answer choice that contains three line items found in Part II of Schedule M-3.

    a. Depletion, depreciation, bad debt expense.

    b. Interest expense, deferred compensation, hedging transactions.

    c. Interest income, hedging transactions, mark-to-market income.

    d. Foreign withholding taxes, net income from nonincludible foreign entities, depreciation.

Lesson 2: Other Tax Issues Facing Contractors

INTRODUCTION

DEFERRED TAXES

This lesson covers deferred taxes, the domestic production activities deduction, and other tax issues and how they apply to construction contractors.

LEARNING OBJECTIVES:

Completion of this lesson will enable you to:
- Recognize components used in calculating deferred taxes.
- Analyze the domestic production activities deduction as well as other tax issues facing contractors.

The guidance and illustrations in this course are based on FASB ASC 740-10 (formerly SFAS No. 109, *Accounting for Income Taxes*).

Overview of the SFAS No. 109 Rules

FASB ASC 740-10 (formerly SFAS No. 109) focuses on the balance sheet and on calculating deferred tax assets and liabilities. Under the asset and liability approach, the tax effects of transactions are reported in the year that the underlying transactions are recorded in the financial statements, but the tax effects are based on the tax rate expected to be in effect in the periods in which the temporary differences are expected to reverse. Changes in tax rates are recognized in the period they are enacted. Deferred income tax provisions are the differences between the deferred tax balance sheet accounts at the beginning and end of the period.

Differences between Financial Reporting under GAAP and Income Tax Reporting

Permanent Differences. Not all differences between financial and income tax reporting are included in calculating income taxes as outlined in the preceding paragraph. Some differences have no tax consequences and the term *permanent differences* has been used to describe income and expenses that are reported in the financial statements but never will be reported in the tax returns. Some common examples include tax-exempt interest on municipal bonds, the dividends received deduction, penalties, the nondeductible portion of business meals and entertainment expense, and certain premiums on officers' life insurance.

Temporary Differences. Temporary differences are differences between financial and income tax reporting that have future tax consequences (that is, differences between the financial and tax bases of assets and liabilities that will result in future taxable or deductible amounts). For most companies, temporary differences may include the following items:

a. Revenues or gains that are taxable after they are recognized in the financial statements.

b. Expenses or losses that are deductible after they are recognized in the financial statements.

c. Revenues or gains that are taxable before they are recognized in the financial statements.

d. Expenses or losses that are deductible before they are recognized in the financial statements.

e. A reduction in the tax basis of depreciable assets because of tax credits.

f. Differences between the assigned values and the tax bases of assets acquired and liabilities assumed in a purchase business combination.

g. Basis adjustments called for by tax law, such as inflation adjustments.

Temporary Differences Unique to Contractors

Although contractors have many of the same types of temporary differences common to all commercial entities, the nature, cause, and magnitude of those differences are somewhat unique for a construction company. That uniqueness is caused primarily by the difference between the percentage-of-completion revenue recognition required by GAAP and variations on that method or the array of other methods allowed by tax law. To help conceptualize that observation, if a contractor recognizes income under the normal accrual method that many commercial entities follow for both GAAP and tax purposes, that contractor would have no temporary differences (with the possible exception of differences between GAAP and tax depreciation methods).

Some of the common types of temporary differences found in the construction industry are as follows:

a. *Differences in Computing Percentage of Completion.* A contractor may be using the PC method for both GAAP and tax; however, a temporary difference may arise because of one of the following circumstances:

   (1) The estimated gross profit on a contract may differ between GAAP and tax because of differences in the types of costs that are allocated to a contract; for example, some general and administrative expenses are required to be included in contract cost for tax purposes but not for GAAP. When the estimated gross profit on a contract differs between tax and GAAP, a temporary difference will occur when the PC method is computed, even if the actual percentage-of-completion is the same, such as 50% complete for both GAAP and tax.

   (2) In addition to affecting the estimated gross profit, the cost capitalization rules discussed in the preceding point could affect the actual percentage computed under the PC method. The numerator, denominator, or both in the cost-to-cost formula could be different solely because of the types of costs allocated to a contract.

   (3) The percentage of completion may differ because the cost-to-cost method must be used for tax purposes; however, other methods such as engineering estimates can be used for GAAP PC purposes.

   (4) A temporary difference can occur even when the cost-to-cost PC method is used for both GAAP and tax because GAAP requires in some instances that uninstalled material charged to a contract be removed from actual cost incurred before computing percentage of completion. However, those costs are not removed under tax law.

   (5) If the contractor elects to use the simplified cost-to-cost method to compute the percentage of completion, a different percentage may be computed than would result under the normal GAAP or tax cost-to-cost method.

b. *Differences between the PC Method and Other Methods Used for Tax.* If a contractor does not use the PC method for tax return preparation, there is an array of other possible methods that might be used. A temporary difference would occur if the contractor uses the PC method for GAAP and any of the following methods for tax purposes.

   (1) The percentage of completion-capitalized cost method (for residential construction contracts).

   (2) The completed-contract method.

   (3) The accrual method.

   (4) The cash method.

   (5) Variations of the accrual or cash method.

c. *Differences Caused by Loss Accruals.* GAAP requires that once a future loss is identified on a contract, regardless of its percentage of completion, that loss must be accrued and reflected in the financial statements. Under tax law, future losses are not recognized.

d. *Differences in Depreciation Methods.* Although temporary differences caused by using different GAAP and tax depreciation methods are common to other commercial entities, those differences may occur more frequently for construction contractors due to the tendency of some contractors to have large investments in fixed assets.

e. *Differences in Accounting for Investments in Joint Ventures, Partnerships, and Other Entities.* A common practice among contractors and real estate developers is to enter into joint ventures or partnership agreements for large contracts or series of contracts. The revenue rules for recognition of income in such ventures may differ between GAAP and tax law.

Deductible temporary differences refers to temporary differences that will result in deferred tax assets. Deductible differences generally represent expenses that have been recognized in the financial statements that will be deducted in future tax returns, such as a provision for warranty costs. They also may represent income recognized in the tax returns but deferred for financial statement reporting, such as subscriptions received in advance.

Taxable temporary differences refers to temporary differences that will result in deferred tax liabilities. Taxable temporary differences generally represent expenses that have been deducted in the tax returns that will be expensed in future financial statements, such as depreciation deducted over shorter lives for tax purposes than permitted by GAAP. They also may represent income recognized in the financial statements that will be taxable in future tax returns, such as use of the percentage-of-completion method of accounting by a small contractor for financial reporting and the completed-contract method for tax reporting.

Which Rates to Use

Deferred taxes are calculated using the enacted tax rates that are expected to be in effect when temporary differences reverse and the amounts are reported for tax purposes. GAAP requires corporations to measure deferred taxes using the maximum effective rate (currently 35%) unless the effect of the graduated rate structure is significant. Because the maximum tax rate of 35% only applies to taxable income in excess of $10 million, for many contractors the maximum rate they will pay will be 34%. For contractors that expect taxable income to be less than $10 million in the year the deferred amounts are reported, it is appropriate to use the 34% tax rate rather than 35% in calculating deferred taxes. In some situations (depending on the amount of temporary differences and carryforwards), the effect of the graduated rates under 34% may be significant. In those situations it may be appropriate to use the graduated rates. When determining the tax rate to be applied to temporary differences, enacted future changes should be considered. However, any other rate changes, regardless of the probability of enactment, should not be considered. Tax rate changes are considered to be enacted when the President signs the bill voted in by Congress. For example, the American Recovery and Reinvestment Act of 2009 (ARRA) was signed by the President on February 17, 2009. Deferred tax calculations made after that date should reflect the ARRA '93 tax rates, if appropriate.

Calculating the Deferred Tax Provision

The deferred tax provision is the difference between the deferred tax asset or liability at the beginning and end of the period. The steps used to calculate the deferred tax provision are as follows:

a. Identify the taxable and deductible temporary differences and loss carryforwards available for tax reporting at the end of the year.

b. Calculate the deferred tax liability by multiplying total taxable differences by the applicable tax rate.

c. Calculate the deferred tax asset by multiplying total deductible differences and loss carryforwards by the applicable tax rate.

d. Identify tax credit carryforwards available for tax reporting at the end of the year and record a deferred tax asset for the total of the carryforwards.

e. Provide a valuation allowance for the portion of the deferred tax asset for which there is more than a 50% chance that the benefit of the deductible differences and carryforwards of losses and tax credits will not be realized.

f. Subtract the *net deferred tax asset or liability* at the end of the year from the net amount at the beginning of the year to determine the deferred tax benefit or expense for the year.

Valuation Allowance

Deferred tax assets are always recognized for deductible temporary differences, operating loss carryforwards, and tax credits. However, if it is more likely than not (that is, more than a 50% likelihood) that all or a portion of the deferred tax asset will not be realized, a valuation allowance must be provided.

Positive and Negative Evidence

Determining whether there is more than a 50% chance that a deferred tax asset will not be realized requires considerable judgment. Assessing the need for a deferred tax asset valuation allowance, involves looking at all available evidence, both negative and positive. FASB ASC 740-10-30-21 and 30-22 (formerly SFAS No. 109) provides some examples of negative and positive evidence that should be considered. If negative evidence exists, it may be difficult to conclude that a valuation allowance is not needed for at least a portion of the deferred tax asset. However, the existence of negative evidence does not always require that a valuation allowance be recorded. In some cases, positive evidence may exist that outweighs the negative evidence, and a conclusion may be reached that a valuation allowance is not necessary.

In cases where there is both positive and negative evidence regarding the realizability of a deferred tax asset, the contractor should determine whether there will be sufficient taxable income to realize the deferred tax asset. In making that determination, the contractor should look to the following four sources of taxable income:

a. Future reversals of existing taxable temporary differences.

b. Taxable income in prior carryback years.

c. Taxable income from tax planning strategies.

d. Expected future taxable income exclusive of reversing temporary differences and carryforwards.

One of the sources of taxable income utilizes tax planning strategies. Tax planning strategies are designed to enable realization of deferred tax benefits. They are methods of increasing future taxable income by (a) changing the reversal pattern of temporary differences (for example, a change from accelerated depreciation methods to straight-line for tax purposes) or (b) initiating future transactions that will generate future taxable income of the appropriate character (for example, selling investments in securities to generate capital gains so that capital loss carryforwards may be used). Tax planning strategies must meet the following three criteria to be considered qualifying strategies:

a. The strategy must be prudent and feasible.

b. The strategy is one that management ordinarily might not take, but would take to prevent an operating loss or tax credit carryforward from expiring unused.

c. The strategy would result in the realization of deferred tax assets.

For each taxing jurisdiction, at least one of the sources listed earlier should be adequate to realize tax benefits. Once it is determined that there is adequate taxable income to realize the tax benefit, the entity need not look at the remaining sources. If after all four sources are considered there is not sufficient taxable income, a valuation allowance should be provided.

Generally, concluding that a valuation allowance is not necessary will be difficult when there is tangible negative evidence such as, but not limited to, the following:

- Losses in recent years.
- History of expired tax benefits.
- Expected future losses.

- Contingencies which, if settled unfavorably, would have a negative impact on operations.

- Brief carryforward periods which make realizations unlikely.

Examples of positive evidence that could support a conclusion that an allowance is not needed (or to reduce an allowance when there is negative evidence) might include, but are not limited to:

- Backlog of contracts or existing contracts that will produce enough revenue to provide reasonable evidence that profits will be sufficient to assure realization of the deferred tax asset.

- Unrealized profits in assets in amounts adequate to provide reasonable evidence the deferred tax asset will be realized.

- Convincing evidence that a loss was abnormal (such as an extraordinary or infrequently occurring item) and evidence that, in fact, the company has a strong earnings history (exclusive of the unusual loss item).

In the absence of significant negative evidence, many contractors may be able to conclude that no valuation allowance is necessary and that a simple computation of deferred tax assets and liabilities is sufficient.

As an example, assume a company has deductible differences of $100,000 (current) and taxable differences of $70,000 (noncurrent). Also assume there are no carryforwards and there is no significant negative evidence as to the need for a valuation allowance. The net deferred tax asset would be $34,000 (34% of $100,000) and deferred tax liability would be $23,800 (34% of $70,000). The $34,000 would be presented as a current asset and the $23,800 as a noncurrent liability. If they both were current or noncurrent, the amounts would be netted and shown as a $10,200 current or noncurrent asset.

Classified Balance Sheet

When the balance sheet is classified, deferred tax amounts are to be classified as current or non-current based on the classification of the related asset or liability. If there is no related asset or liability, the deferred tax asset or liability is to be classified as current to the extent of the tax effect of the temporary difference expected to reverse within one year. The remaining amounts are noncurrent. FASB ASC 740-10-25-25 (formerly SFAS 109, Paragraph 15), lists use of the percentage-of-completion method for GAAP and the completed-contract for tax purposes as an example of when the deferred tax asset and liability cannot be identified with a specific account on the balance sheet. Accordingly, the tax effect related to the portion of the deferred income for tax purposes expected to reverse within one year is to be classified as current. The remaining amount, if any, would be noncurrent. For contractors who present a classified balance sheet, the deferred tax assets and/or liabilities relating to contracts in progress will be classified as current.

Illustration of Deferred Taxes on HBC

Exhibit 2-1 illustrates the application of deferred tax accounting to the HBC case study.

Exhibit 2-1

Highway and Bridge Company
Deferred Tax Calculation

December 31, 20X2

Line No.	Description	Computation	Tax Method		
			Current	Noncurrent	Total
1	Temporary differences—increase (decrease) future taxable income:				
	Cumulative difference between GAAP PC and method used on tax return:				
	No. 265		$ —	$ —	
	No. 268		(320,000)	—	
	No. 269		(60,000)	—	
	No. 270		(48,000)	—	
2	Other temporary differences				
	Accumulated depreciation[a]	(Tax less book)	—	20,000	
3	Net deferred taxable income	1 +/− 2	(428,000)	20,000	
4	Tax rate expected to be in effect[b]		34 %	34 %	
5	Tax liability (asset) on deferred income, December 31, 20X2[c]	3 × 4	(145,520)	6,800	$ (138,720)
6	Tax liability (asset) on deferred income, December 31, 20X1	(12/31/X1 Balance Sheet)	(42,220)	1,500	(40,720)
7	Deferred tax expense (benefit)[de]	5 − 6	$ (103,300)	$ 5,300	$ (98,000)

Notes:

[a] The HBC case study has not previously included a depreciation temporary difference. The difference is added here for illustrative purposes.

[b] Future taxable income is estimated to exceed $150,000 but be less than $10,000,000. Therefore, a tax rate of 34% is used to calculate the deferred tax provision.

[c] The deferred tax liability (asset) resulting from differences in the recognition of gross profit on construction contracts is classified as current. The deferred tax liability resulting from differences in depreciation is classified as noncurrent because the asset which gave rise to the difference in depreciation, property and equipment, is classified as noncurrent.

[d] The deferred tax provision would be shown on HBC's GAAP basis income statement as follows:

[e] No uncertain tax positions were identified during the FIN 48 (FASB ASC 740) analysis.

Income before tax	$ 64,000
Income taxes:	
Currently payable	109,000
Deferred benefit	(98,000)
	11,000
Net Income	$ 53,000

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. What is the difference between the deferred tax balance sheet accounts at the beginning and end of the period?

    a. A permanent difference.

    b. A temporary difference.

    c. Deferred income tax provisions.

24. Which of the following would result in a *taxable temporary difference*?

    a. A provision for warranty costs.

    b. Retirement benefit costs.

    c. Subscriptions received in advance.

    d. The percentage-of-completion method of accounting by a small contractor for financial reporting and the completed-contract method for tax reporting.

25. Which of the following is an example of positive evidence that could support a conclusion that a valuation allowance is **not** needed?

    a. Recent year losses.

    b. Tax benefits that expired in previous years.

    c. Assets with unrealized profits in amounts adequate to provide reasonable evidence the deferred tax asset will be realized.

    d. Contingencies that would have a negative impact on operations if settled unfavorably.

26. Afterthoughts Construction Co. is a small contractor with deductible differences of $45,000 (current) and taxable differences of $28,000 (noncurrent) and taxable income less than $10 million. Afterthoughts has no carryforwards and no significant negative evidence as to the need for a valuation allowance. How should the deferred taxes be presented?

    a. $5,780 current asset.

    b. $15,300 current asset; $9,520 noncurrent liability.

    c. $15,750 current asset; $9,800 noncurrent liability.

    d. $45,000 current asset; $28,000 noncurrent liability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

23. What is the difference between the deferred tax balance sheet accounts at the beginning and end of the period? **(Page 181)**

    a. A permanent difference. [This answer is incorrect. Some differences have no tax consequences and the term *permanent differences* has been used to describe income and expenses that are reported in the financial statements but never will be reported in the tax returns.]

    b. A temporary difference. [This answer is incorrect. Temporary differences are differences between financial and income tax reporting that have tax consequences.]

    c. Deferred income tax provisions. [This answer is correct. Deferred income tax provisions are the difference between the deferred tax balance sheet accounts at the beginning and end of the period.]

24. Which of the following would result in a *taxable temporary difference*? **(Page 183)**

    a. A provision for warranty costs. [This answer is incorrect. Deductible temporary differences generally represent expenses that have been recognized in the financial statements that will be deducted in future tax returns, such as a provision for warranty costs.]

    b. Retirement benefit costs. [This answer is incorrect. Retirement benefit costs are expensed in the financial statements and deducted in tax years in which contributions are paid; this represents a deductible temporary difference.]

    c. Subscriptions received in advance. [This answer is incorrect. Deductible temporary differences also may represent income recognized in the tax returns but deferred for financial statement reporting, such as subscriptions received in advance.]

    d. The percentage-of-completion method of accounting by a small contractor for financial reporting and the completed-contract method for tax reporting. [This answer is correct. Taxable temporary differences may represent income recognized in the financial statements that will be taxable in future tax returns, such as use of the percentage-of-completion method of accounting by a small contractor for financial reporting and the completed-contract method for tax reporting.]

25. Which of the following is an example of positive evidence that could support a conclusion that a valuation allowance is **not** needed? **(Page 185)**

    a. Recent year losses. [This answer is incorrect. Losses in recent years represent negative evidence that would most likely conclude a valuation allowance is needed. An allowance would reduce the net deferred tax asset to an amount that is more likely than not to be realized.]

    b. Tax benefits that expired in previous years. [This answer is incorrect. Having a history of expired tax benefits represents negative evidence, which would conclude that a valuation allowance is needed.]

    c. Assets with unrealized profits in amounts adequate to provide reasonable evidence the deferred tax asset will be realized. [This answer is correct. Backlog of contracts or existing contracts that will produce enough revenue to provide reasonable evidence that profits will be sufficient to assure realization of the deferred tax asset, unrealized profits in assets in amounts adequate to provide reasonable evidence the deferred tax asset will be realized, and convincing evidence that a loss was abnormal and evidence that, in fact, the company has a strong earnings history are all examples of positive evidence that could support a conclusion that a valuation allowance is not needed.]

    d. Contingencies that would have a negative impact on operations if settled unfavorably. [This answer is incorrect. Contingencies which, if settled unfavorably, would have a negative impact on operations is an example of negative evidence that would most likely conclude a valuation allowance is needed.]

26. Afterthoughts Construction Co. is a small contractor with deductible differences of $45,000 (current) and taxable differences of $28,000 (noncurrent) and taxable income less than $10 million. Afterthoughts has no carryforwards and no significant negative evidence as to the need for a valuation allowance. How should the deferred taxes be presented? **(Page 185)**

    a. $5,780 current asset. [This answer is incorrect. Because they are both not either current or noncurrent, you cannot net out the two results.]

    b. $15,300 current asset; $9,520 noncurrent liability. [This answer is correct. The deferred tax current asset is calculated as $45,000 × 34% = $15,300 and the deferred tax noncurrent liability is calculated as $28,000 × 34% = $9,520.]

    c. $15,750 current asset; $9,800 noncurrent liability. [This answer is incorrect. This answer choice incorrectly calculates the deferred tax asset and liability at a rate of 35%; because this taxpayer is a small contractor a rate of 34% would be used.]

    d. $45,000 current asset; $28,000 noncurrent liability. [This answer is incorrect. These are the temporary difference. The correct tax rate must be applied to determine the asset or liability.]

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

The American Jobs Creation Act of 2004 created Internal Revenue Code Section 199 which allows qualifying taxpayers a deduction for "qualifying production activities." The new deduction was intended to benefit American manufacturers competing internationally and was a replacement for the Extraterritorial Income Exclusion, which was repealed after the World Trade Organization found it violated international trade agreements. The wording in the new Code Section, although initially intended for manufacturers, specifically includes both construction performed within the United States and architectural and engineering services for U.S. construction projects. On January 19, 2005, initial guidance relating to the IRC 199 was issued by the IRS in Notice 2005-14. Temporary regulations were issued in November 2005 followed by final regulations being issued May 2006. For tax years beginning on or after June 1, 2006, Notice 2005-14 can no longer be relied on. The remainder of this section is a brief discussion of the highlights of the new deduction.

Under the Act, a taxpayer engaged in a qualified production activity (QPA) is allowed a deduction against gross income equal to 3% of "qualified production activities income" (QPAI) for tax years beginning in 2005 and 2006. The percentage increases to 6% for tax years 2007–2009, and to 9% for tax years after 2009. To calculate the deduction, the applicable percentage is applied to the lesser of QPAI or taxable income after the utilization of any NOL carryforwards (adjusted gross income for individual taxpayers). The calculated deduction is limited to 50% of W-2 wages, including elective deferrals. Rev. Proc. 2006-22 and the final regulations describe three alternative methods for determining W-2 wages. Amounts paid to independent contractors are not included in W-2 wages, nor are guaranteed payments by partnerships or income distributions by pass-through entities. The Tax Increase Prevention and Reconciliation Act of 2006 (TIPRA) amended Section 199 to include in W-2 wages only those amounts properly allocable to DPGR and owners of pass-through entities are now allowed to use their pro rata share of allocable wages in determining the deduction. These provisions are effective for tax years beginning after May 17, 2006. The deduction is allowable for both regular tax and AMT. For purposes of calculating the deduction for AMT, C corporations should substitute AMTI for taxable income.

Qualified Production Activities (QPA)

QPA is defined in IRC Sec. 199(c)(4)(A) and includes construction performed in the United States and engineering or architectural services performed in the United States for construction projects in the United States.

Domestic Production Gross Receipts (DPGR)

The regulations define DPGR from construction activities as a taxpayer's gross receipts from construction activities that are directly related to erection or substantial renovation of real property located in the United States, including residential or commercial buildings and infrastructure improvements such as roads, power lines, water systems, railroad spurs, and communication facilities. Gross receipts from tangible personal property are excluded if they are 5 percent or more of the total gross receipts from the construction project. Construction for this purpose does not include activities performed by others that are secondary to the construction, such as hauling debris or delivering materials, even if the service is essential. Painting and land improvements are considered to be construction activities only if performed in connection with other activities that constitute erection or substantial renovation of real property.

Gross receipts from architectural and engineering activities qualify as DPGR only if performed in the United States for construction projects within the United States. The taxpayer providing the service must be able to substantiate that the services relate to a U.S. construction project. Engineering services include services that require an engineering education, training, experience, and the application of specialized knowledge relating to construction. Services performed for a construction project within the United States will qualify as DPGR even if the project is not ultimately undertaken or completed.

What Are Gross Receipts? For purposes of the deduction, gross receipts are defined as gross receipts as determined under the taxpayer's method of accounting for federal income tax purposes. For example, a taxpayer using the cash method of accounting would include the receipts in DPGR in the tax year in which the funds were

+received regardless of when the income was recognized for financial reporting purposes. Gross receipts include any of the following:

a. Any sale (net of returns and allowances), exchange or other disposition, or lease, rental, or license of qualifying production property manufactured, produced, or extracted by a taxpayer within the United States.

b. Amounts received for services.

c. Income from investments (such as dividends, interest, rents, etc.) regardless of whether or not derived in the ordinary course of a taxpayer's trade or business.

d. Incidental income whether or not connected with a taxpayer's trade or business.

e. Taxes collected by a taxpayer from customers but which are imposed on the taxpayer.

In general, gross receipts do not include any receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer to a related party and gross receipts are not reduced by costs of sales, construction costs, or the cost of property sold, including cost of real or business property sold.

Gross receipts from construction may qualify as DPGR if the receipts relate to the erection or substantial renovation of property in the United States. Reg. 1.199-3(m)(5) indicates that *substantial renovation* is the renovation of a major component or substantial structural part of real property that materially increases the value or useful life of the property, or that adapts the property to a new or different use. Qualifying taxpayers must be engaged in a construction trade or business on a regular and ongoing basis.

The taxpayer must determine which gross receipts qualify as DPGR, and the allocation must be reasonable and acceptable to the IRS. Regulation 1.199-3(d) lists a series of factors which should be taken into account including the methods used by the taxpayer for other purposes, consistency, and the burden of compliance on taxpayer.

De Minimis Gross Receipts. If less than 5% of a taxpayer's gross receipts are non-DPGR gross receipts, the taxpayer can treat all of its gross receipts as DPGR and no allocation of expenses is required. For example, a contractor with gross receipts from construction activities of $15,000,000 and other gross receipts of $500,000 can treat all of its gross receipts as DPGR. However, if the contractor had other nonqualifying gross receipts of $1,000,000, the contractor would be required to allocate expenses among the various activities.

Qualified Production Activities Income (QPAI)

QPAI is defined as the excess of domestic production gross receipts (DPGR) over the sum of:

a. the costs of goods sold allocable to DPGR,

b. other deductions, expenses, or losses directly allocable to DPGR, and

c. a ratable portion of other deductions, expenses, and losses not directly allocable to DPGR or any other income class.

Three methods for allocation of direct and indirect expenses to DPGR are set forth in the regulations. Taxpayers with average annual gross receipts in excess of $10 million must use the methodology of IRC Sec. 861, even if the taxpayer has never engaged in international transactions. Other taxpayers generally may use one of two simplified methods:

- the simplified deduction method, or
- the small business simplified method.

The simplified deduction method may be used by taxpayers with average annual gross receipts of $100 million or less, or with assets of $10 million or less. (Average annual gross receipts are the average annual gross receipts of

a taxpayer for the three preceding years. Total assets are the total assets used in a taxpayer's trade or business at the end of the preceding tax year.) Under the simplified method, deductions are ratably apportioned between DPGR and non-DPGR based on relative gross receipts. The simplified method cannot be used to apportion cost of goods sold.

The small business simplified method may be used by taxpayers with average annual gross receipts of $5 million or less and those eligible to use the cash method under Rev. Proc. 2002-28. (Those who qualify to use this method generally include C corporations with average annual gross receipts of $5 million or less and other taxpayers with average annual receipts of $10 million or less that are not prohibited from using the cash method under Section 448.) Under the small business simplified method, deductions and cost of goods sold are ratably apportioned between DPGR and non-DPGR based on relative gross receipts.

Members of an expanded affiliated group are treated as a single taxpayer for purposes of calculating the deduction. An expanded affiliated group is defined by substituting 50% for 80% in IRC Section 1504. A single deduction is computed for the group and then the deduction is allocated to each member of the group based on each member's respective amount, if any, of the QPAI.

Pass-through Entities

The Section 199 deduction cannot be claimed by pass-through entities, such as partnerships, S corporations, LLCs, or estates and trusts. Instead the deduction calculations and limits are applied at the owner level, and each owner of a pass-through entity must compute its own deduction. The pass-through entity must allocate to each owner their prorata share of QPAI, wages and other items needed to calculate the deduction and furnish the information to the owner. Partnerships may make special allocations.

Accounting Issues

Although the domestic production activities deduction will be beneficial to many contractors, there will be increased accounting costs, especially if the construction company has both qualifying and nonqualifying activities. Eligible and ineligible costs must be segregated and tracked by the contractor's accounting system and a method of allocating indirect costs to qualifying and nonqualifying projects must be established.

Impact on Deferred Taxes. After the American Jobs Creation Act of 2004 was signed, the question arose regarding whether to account for the qualified production activities deduction as a special deduction or a tax rate reduction when determining deferred taxes. To answer this question, in December 2004 the FASB issued FASB Staff Position No. FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004* (FASB ASC 740-10). According to the FSP, the deduction should be treated as a special deduction under SFAS No. 109 (FASB ASC 740).

Example of the Calculation of the Qualifying Production Activities Deduction

To illustrate how the deduction should be calculated, assume the following information about ABC Construction Company for the year ended December 31, 20X5:

- Taxable income was $200,000.
- Qualified production activities income (QPAI) was $180,000.
- W-2 wages were $550,000, all related to QPAI.
- The QPA deduction is 3%.

Based on this information, the QPA deduction would be calculated as follows:

Lesser of taxable income or QPAI	$ 180,000
Multiplied by the QPA deduction percent	× 3%
Tentative QPA deduction amount	$ 5,400

One last step is to compare the tentative QPA deduction amount to 50% of W-2 wages. In this example, the $5,400 deduction amount is much less than 50% of W-2 wages, so the deduction amount in $5,400.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. Under the American Jobs Creation Act of 2004, a taxpayer engaged in a qualified production activity (QPA) is allowed a deduction against gross income equal to what percent of qualified production activities income (QPAI) for 2007?

    a. 3%.

    b. 6%.

    c. 9%.

28. Which of the following activities would qualify as domestic production gross receipts (DPGR)?

    a. Engineering activities performed in the U.S. for construction projects within the U.S.

    b. Architectural activities performed in a foreign country.

    c. Construction activities involving delivering material.

    d. Painting activities related to a company changing the colors in the logo that adorns the front of their office building.

29. Use the following information regarding A&B Construction Co. for year ended December 31, 20X6.

    - Taxable income was $320,000.
    - QPAI was $280,000.
    - W-2 wages were $430,000, all related to QPAI.
    - The QPA deduction is 3%.

    Calculate A&B Construction Co.'s QPA deduction amount.

    a. $8,400.

    b. $9,600.

    c. $12,900.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

27. Under the American Jobs Creation Act of 2004, a taxpayer engaged in a qualified production activity (QPA) is allowed a deduction against gross income equal to what percent of qualified production activities income (QPAI) for 2007? **(Page 190)**

    a. 3%. [This answer is incorrect. 3% was used for tax years 2005 and 2006.]

    b. 6%. [This answer is correct. For tax years 2007–2009, a taxpayer engaged in a QPA is allowed a deduction against gross income equal to 6% of QPAI.]

    c. 9%. [This answer is incorrect. The percentage will increase to 9% for tax years after 2009.]

28. Which of the following activities would qualify as domestic production gross receipts (DPGR)? **(Page 190)**

    a. Engineering activities performed in the U.S. for construction projects within the U.S. [This answer is correct. Gross receipts from architectural and engineering activities qualify as DPGR only if performed in the United States for construction projects within the United States.]

    b. Architectural activities performed in a foreign country. [This answer is incorrect. Because the architectural activities were performed in a foreign country they do not qualify as DPGR.]

    c. Construction activities involving delivering material. [This answer is incorrect. Construction activities for the purpose of determining DPGR do not include activities performed by others that are secondary to the construction, such as delivering materials, even if the service is essential.]

    d. Painting activities related to a company changing the colors in the logo that adorns the front of their office building. [This answer is incorrect. Painting and land improvements are considered to be construction activities only if performed in connection with other activities that constitute erection or substantial renovation of real property.]

29. Use the following information regarding A&B Construction Co. for year ended December 31, 20X6.

    - Taxable income was $320,000.
    - QPAI was $280,000.
    - W-2 wages were $430,000, all related to QPAI.
    - The QPA deduction is 3%.

    Calculate A&B Construction Co.'s QPA deduction amount. **(Page 193)**

    a. $8,400. [This answer is correct. In this example QPA is calculated as $280,000 × 3% = $8,400. 3% of the lesser of taxable income of $320,000 or QPAI of $280,000 is $8,400. The $8,400 is less than 50% of W-2 wages of $430,000 ($430,000 × 50% = $215,000.]

    b. $9,600. [This answer is incorrect. This answer incorrectly uses the taxable income to calculate QPA. Taxable income is used in the calculation only if it is less than QPAI.]

    c. $12,900. [This answer is incorrect. This answer incorrectly uses the W-2 wages to calculate the QPA deduction. A percentage of W-2 wages is used as a limitation in calculating the QPA deduction.]

OTHER TAX ISSUES FACING CONTRACTORS

Electing an Accounting Method

Reg. Sec. 1.446-1(e)(1) delineates the general requirements for electing an accounting method. Normally, the taxpayer must adopt a method of accounting for long-term contracts on the initial tax return or on the first tax return that contains income from a long-term contract. Reg. Sec. 1.460-1(a)(2) allows contractors exempt from Section 460 to use any method of accounting permitted by Reg. Sec. 1.460-4(c) and IRC Sec. 446. No special election is required. However, a taxpayer may wish to include on its initial tax return for the year in which the taxpayer first has long-term contracts a statement electing its method of accounting for long-term contracts.

Changing an Accounting Method

The rules relating to changes in accounting method are complex and there have been numerous changes over the past few years. The rules that may be applicable to contractors are outlined in the following paragraphs; however, a complete discussion of the rules is beyond the scope of this *Course*. Prior to making a change in accounting method, the taxpayer and the practitioner should familiarize themselves with the applicable IRS pronouncements and procedures.

Automatic Changes in Accounting Method. The softening of the IRS stance regarding the use of the cash method of accounting allows many taxpayers to change from their current method of accounting to the cash method by utilizing the automatic change procedures outlined in Rev. Proc. 2001-10 (taxpayers with average annual gross receipts of $1 million or less) or Rev. Proc. 2002-28 (taxpayers with average annual gross receipts of $10 million or less). The automatic procedures allow qualifying taxpayers to switch to the cash method by filing an original Form 3115 with their tax return for the year of change. A copy of Form 3115 must be filed with the IRS National Office. For taxpayers who have already filed their returns, an amended return along with Form 3115 may be filed within six months of the original due date of the return.

Rev. Proc. 2008-52, as amplified, modified, and clarified by Rev. Proc. 2009-39, grants automatic approval to taxpayers switching from the cash or hybrid cash methods of accounting to the accrual method of accounting. Form 3115 must be completed and attached to the taxpayer's timely filed (including extensions) return for the year of change and a copy filed with the IRS National Office. Negative adjustments are taken into account in full in the year of change and most positive adjustments are taken into account over four years, except for taxpayer initiated changes listed under Reg. 1.460-4(c) and (g) where the cut-off method is required and an IRC Sec. 481(a) adjustment is not permitted. However, the proposed regulations issued August 4, 2008, if adopted, would allow an IRC Sec. 481(a) adjustment for certain limited changes effective for tax years beginning after the date the regulations are finalized. There is no user fee for taxpayers applying under Rev. Procs. 2008-52 and 2009-39.

Non-automatic Changes in Accounting Method. Generally most contractors who want to change their method of accounting will not qualify for an automatic change in accounting method. Instead they must obtain approval from the IRS Commissioner using the procedures outlined in Rev. Proc. 97-27. The change is requested by filing Form 3115 and paying a user fee [$2,500 for applications for a single accounting method change postmarked after January 31, 2006 and received on or before February 1, 2008. For applications received after February 1, 2008, the fee has increased to $3,800. If the IRS believes that changes to more than one accounting method are being requested, they will ask for additional user fees (Rev. Proc. 2010-1)]. The Form 3115 may be filed any time during the tax year for which the taxpayer is requesting the change. The change will be effective upon approval. Currently, the IRS has a backlog of requests for changes in accounting methods. Therefore, taxpayers wishing to change their method of accounting should file as early as possible. A positive Sec. 481(a) adjustment is taken into account over four years and a negative adjustment is taken into account in full in the year of change. There are limited exceptions to these rules. Generally, a change in a long-term contract method of accounting is approved on a cut-off basis.

If the taxpayer is requesting a change to or from the cash method of accounting along with a change to a special method, such as a long-term contract method of accounting, the automatic procedures cannot be used and the taxpayer must follow the procedures of Rev. Proc. 97-27.

Sale or Other Disposition of Uncompleted Contracts. In May 2002, the IRS released final regulations relating to reporting of income and deductions for most transactions, other than partnership transactions, that result in a

mid-contract change in taxpayer. Final regulations for transactions involving partnerships were issued July 2004. When there is a mid-contract change in taxpayer, contracts are divided into two categories: constructive completion transactions and step-in-the-shoes transactions. Any transaction that is not a step-in-the-shoes transaction is a constructive completion transaction. The regulations also provide that a contribution to a partnership in a IRC Sec. 721(a) transaction, a transfer of a partnership interest, or a distribution from a partnership to which IRC Sec. 731 applies (other than distribution of a contract accounted for using a long-term contract method of accounting) are step-in-the-shoes transactions. The final regulations, including the regulations applicable to partnership transactions, apply to transactions occurring on or after May 15, 2002. Application of the rules found in the regulations is not a change in accounting method and therefore does not require filing Form 3115.

Step-in-the-shoes Transactions. Step-in-the-shoes transaction rules apply to the following transactions (all transactions listed in this category are "tax-free" transactions):

- Transfers to which IRC Section 361 applies, if the transfer is in connection with a reorganization described in IRC Sec. 368(a)(1)(A), (C), or (F).
- Transfers to which IRC Section 361 applies, if the transfer is in connection with a reorganization described in IRC Sec. 368(a)(1)(D) or (G), provided the requirements of IRC Sec. 354(b)(1)(A) and (B) are met.
- Distributions under IRC Sec. 332 to an 80% distributee.
- Transactions described in IRC Sec. 351(transfer to controlled corporation).
- Transfers of S corporation stock, including sales.
- Conversion to or from S corporation status.
- Members joining or leaving a consolidated group.
- Contributions to which IRC Sec. 721(a) applies, including a partnership's transfer of all of its assets and liabilities to a second partnership and the subsequent liquidation of transferor partnership.
- Transfers of partnership interests.
- Distributions to which IRC Sec. 731 applies (other than the distribution of a contract accounted for under a long-term contract method of accounting).
- Any other transaction designated by the IRS.

In a step-in-the-shoes transaction, the old taxpayer's obligation to account for the contract terminates on the date of the transaction and is assumed by the new taxpayer. As a result, if the old taxpayer is reporting income from the contract on the percentage-of-completion method of accounting, the old taxpayer must recognize income up to the date of transfer. If the old taxpayer is reporting on the completed-contract method, it is not required to report any income nor may it deduct any contract costs. Beginning on the date of the transaction, the new taxpayer assumes the accounting method used by the old taxpayer. Both the contract price and allocable contract costs are based on amounts taken into account by both parties. In the case of tax avoidance transactions, the regulations allow the IRS to allocate income between the old and new taxpayers.

In certain transactions, such as IRC Sec. 351 transfers or divisive "D" reorganizations, the transferor's tax basis in the stock of the transferee is determined by reference to the tax basis of the assets transferred. In these transactions, the regulations require that the old taxpayer adjust its basis in the stock of the new taxpayer by the difference between the amount the old taxpayer recognized with respect to the contract and the amount the old taxpayer has received or will receive under the contract.

Constructive Completion Transactions. Under the regulations, all transactions not listed previously (taxable transfers) must follow the rules for constructive completion contracts. In a constructive completion transaction the old taxpayer recognizes income from the contract based on the amount paid to or by the old taxpayer to or from the

new taxpayer for the contract. Similarly the new taxpayer is treated as entering into a new contract as of the date of the transaction with the contract price adjusted for amounts paid to or by the former taxpayer.

Partnership Transactions. The final regulations related to mid-contract changes in taxpayers involving partnership transactions were released on July 16, 2004 and apply to transactions occurring on or after May 15, 2002. The rules outlined in the final regulations contain many illustrative examples, which are summarized as follows:

- Generally, a contribution to a partnership of a long-term contract is a step-in-the-shoes transaction.
  - The contributing partner must recognize any income or loss (as determined under the contributing partner's method of accounting for long-term contracts) for the period ending on the date of the contribution.
  - The partnership must calculate the amount of built-in gain or loss the contributing partner would have recognized if the contract had been sold at fair market value immediately prior to the contribution. This built-in income or loss is allocated to the contributing partner over the life of the contract.
  - The contributing partner must increase his or her tax basis in the partnership by the gross receipts that the partner has recognized and reduce his or her basis by the gross receipts the partner has received. The basis cannot be reduced below zero.
  - The partnership must reduce the total contract price by the income recognized by the contributing partner.
- The transfer of a partnership interest is a step-in-the-shoes transaction.
  - Long-term construction contracts are unrealized receivables within the meaning of IRC Sec. 751, and the selling partner will recognize ordinary income or loss as if the partnership had disposed of the contract at fair market value in a constructive completion transaction.
  - The acquiring partner may be able to offset contract income by utilizing the basis adjustment provisions of IRC Sec. 743(b).
  - The step-in-the-shoes rules apply to the transfer of a partnership interest only if the partnership books are closed with respect to long-term contracts. If the partnership books are not closed, the partnership will report income from long-term contracts as though no change in taxpayer had occurred and income from the contract may be allocated under any reasonable method.
- A distribution by a partnership of a long-term contract is a constructive completion transaction.

Built-in Gains upon Conversion from C Corporation to S Corporation

Corporations considering a conversion from C to S status should be aware of a special built-in gains tax on unreported earnings. A built-in gain is defined as the excess of the aggregate fair market value over the aggregate tax basis of the assets of the corporation as of the date the S election goes into effect. Built-in gains can be reduced by built-in losses and deductions, with the net gain subject to the special tax. Because built-in gain includes the unreported gross profit from long-term contracts, a conversion from C to S status can be costly for the owners of a construction business, especially contractors using the completed contract method of accounting.

The built-in gains tax is a 35% corporate level tax (the highest corporate tax rate) paid on certain gains realized by the corporation during its first 10 years (7 years for S elections made in the 2002 and 2003 tax years) as an S corporation. Because the tax is paid by the corporation and the after-tax effect of the built-in gain is also passed through to the owners of the S corporation as earnings subject to personal taxation, the gains are taxed twice at a high effective rate. To illustrate, assume that a contractor converts from C to S status during 20X1. At the time of conversion, the contractor has four contracts in progress on which $100,000 of gross profit would have been recognized if the percentage-of-completion method had been used. However, the contractor qualifies for exemption from Code Section 460 under the small contractor's exemption and therefore uses the completed-contract

method for tax purposes. If all of the contracts were completed during 20X2, the following taxes relating to these four contracts would be due:

Percentage-of-completion earnings at date of conversion	$ 100,000
Earnings actually reported for tax purposes as of date of conversion	—
Built-in gains subject to tax	100,000
Special built-in gains tax rate	× 35%
Built-in gains tax to be paid by the corporation	$ 35,000
Earnings passed through to the S corporation owners ($100,000 − $35,000)	$ 65,000
Personal tax rate (maximum personal rate assumed)	× 35%
Personal tax paid by the S corporation owners	$ 22,750

As indicated, the S corporation owners paid $57,750 of total tax—$35,000 at the corporate level and another $22,750 at the personal level. This represents an effective rate of over 57% on the $100,000 of unrecognized contract profits as of the date of conversion to S corporation status. The effective rate will be even higher if state taxes are considered.

As the above example illustrates, a contractor should carefully consider the consequences of converting from C status to S status without proper planning. The effect of the built-in gains tax can be reduced or eliminated by using some of the following approaches:

a. Some corporations may be able to avoid the built-in gains tax by deferring the disposition of assets with built-in gains for 10 years (7 years for S elections made in the 2002 and 2003 tax years) after electing S status. As a contract is completed, the asset is considered disposed of for purposes of computing the built-in gains tax. Since a contractor cannot usually defer contract completion for 10 years (7 years for S elections made in the 2002 and 2003 tax years), this approach will rarely be feasible for construction contractors.

b. The effect of the special built-in gains tax can usually be minimized by electing the S corporation conversion at a point where unreported gross profit from contracts in progress is at a minimum. Expenses attributable to periods prior to the effective date of the S election, which are taken into account after the effective date, reduce the amount of income subject to built-in gains tax. These built-in expenses would reduce the amount of income subject to built-in gains tax.

Independent Contractor versus Employee

The IRS continues to attack the treatment of certain persons who perform work as independent contractors rather than as employees. They have targeted the construction industry as an industry where the issue will be vigorously pursued. The cost to any business that is forced to reclassify workers from independent contractor status to employee status can be substantial. The costs may include:

- Additional payroll taxes (including employee's and employer's Social Security and Medicare taxes, unemployment taxes, and employee's income taxes), penalties, and interest.

- Potential back overtime pay under wage and hour laws.

- Additional pension plan contributions or possible loss of deduction for an employee benefit plan for failure to contribute the proper amounts. (In the extreme, it could even mean loss of exempt status for the plan itself under nondiscrimination and minimum coverage rules.)

If a worker classified as an independent contractor is reclassified, the employer is entitled to a credit for any taxes the worker paid on the reclassified income, but only to the extent that it can show that the taxes were paid. The burden of proof is on the employer. The credit applies only to the employer's liability for failure to withhold. It does not apply to the employer's share of the payroll taxes. Section 530 of the Revenue Act of 1978 (a non-Revenue

Code provision) limits the application of undue harsh results by establishing a safe harbor. It has the effect of prohibiting retroactive reclassifications when the taxpayer meets the following conditions:

- The taxpayer did not treat the worker as an employee for any period.
- All returns (e.g. Forms 1099) that were required to be filed for periods after 1978, with respect to the worker, were filed *and* were filed consistently with the treatment of the worker as a non-employee.
- Neither the taxpayer nor a predecessor taxpayer treated any worker holding a substantially similar position as an employee in any period after 1977.
- The taxpayer had a reasonable basis for treating the worker as an independent contractor.

Generally a practitioner not familiar with these requirements should research the subject or consult with a CPA or attorney knowledgeable in this area. This *Course* is to not intended to provide detailed guidance on this subject.

A contractor can take the following steps to minimize the risks of having workers reclassified from independent contractors to employees:

- Use a written agreement between the contractor and subcontractor defining the relationship and terms of the work situation.
- Avoid using the terms "hired," "employee," "employed," and other similar terms when referring to an independent contractor.
- Do not have an experienced employee working alongside of and doing the same work as the independent contractor.
- Any documents should set forth specific completion dates and contain liquidated damages clauses.
- Avoid payment of independent contractor's expenses, except as provided for in the contract. Those that are paid should be included in the subcontractor's total price.
- Have the subcontractor furnish his or her own tools and materials.

The IRS issued a guide titled "Employee or Independent Contractor" (IRS Training Material 3320-102 10/96) for use in training its examiners on how to determine proper worker classification as employees or independent contractors. This training manual indicates that the most significant categories of evidence are the right to control and direct the result of the service and the means of achieving the result, financial control, and the relationship of the parties. The training manual is available on the IRS website at **www.irs.gov/pub/irs-utl/emporind.pdf**. In addition, guidance on worker classification is provided in Publication 15-A, "Employer's Supplemental Tax Guide," and Publication 1779, Independent Contractor or Employee Brochure." IRS publications are available for download from the IRS website at **www.irs.gov/formspubs/index.html**.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. Albert Construction Company is switching from the cash method of accounting to the accrual method of accounting. Which of the following would grant them automatic approval of this change?

    a. Rev. Proc. 2001-10.

    b. Rev. Proc. 2002-28.

    c. Rev. Proc. 2008-52.

    d. Rev. Proc. 97-27.

31. Which of the following is a tax Corporations considering a conversion from C to S status should be aware of?

    a. Built-in gains tax.

    b. Built-in losses tax.

    c. Unreported earnings tax.

    d. Alternative minimum tax.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

30. Albert Construction Company is switching from the cash method of accounting to the accrual method of accounting. Which of the following would grant them automatic approval of this change? **(Page 197)**

    a. Rev. Proc. 2001-10. [This answer is incorrect. Rev. Proc. 2001-10 grants automatic approval from a company's current accounting method to the cash method as long as the taxpayer's average annual gross receipts are $1 million or less.]

    b. Rev. Proc. 2002-28. [This answer is incorrect. Rev. Proc. 2002-28 grants automatic approval to the cash method of accounting if the taxpayers average annual gross receipts are $10 million or less.]

    c. Rev. Proc. 2008-52. [This answer is correct. Rev. Proc. 2008-52 grants automatic approval to taxpayers switching from the cash or hybrid cash methods of accounting to the accrual method of accounting.]

    d. Rev. Proc. 97-27. [This answer is incorrect. Generally most contractors who want to change their method of accounting will not qualify for an automatic change in accounting method. Instead they must obtain approval from the IRS Commissioner using the procedures outlined in Rev. Proc. 97-27.]

31. Which of the following is a tax corporations considering a conversion from C to S status should be aware of? **(Page 199)**

    a. Built-in gains tax. [This answer is correct. Corporations considering a conversion from C to S status should be aware of a special built-in gains tax on unreported earnings. A built-in gain is defined as the excess of the aggregate fair market value percentage over the aggregate tax basis of the assets of the corporation as of the date the S election goes into effect.]

    b. Built-in losses tax. [This answer is incorrect. While built-in losses reduce built-in gains, there is not a separate tax for built-in losses per the IRS Code.]

    c. Unreported earnings tax. [This answer is incorrect. While there is not a unreported earnings tax, C corporations that convert into S corporations should be aware of certain taxes that may apply on unreported earnings per the IRS Code.]

    d. Alternative minimum tax. [This answer is incorrect. C corporations are subject to AMT while S corporations are not. S corporation shareholders, however, may be subject to the individual AMT per the IRS Code.]

SMALL CONTRACTOR CASE STUDY

A case study of Electric Man, Inc., a fictitious electrical subcontractor, is presented in this section to illustrate the differences in calculating the federal income taxes, alternative minimum taxes, and look-back for contractors meeting the small contractor's exemption in IRC Sec. 460(e)(1)(B).

Background Information

Electric Man, Inc. (EMI) is a calendar-year C Corporation owned 100% by Mr. Fred Wire. EMI is an electrical services subcontractor that designs and installs electrical systems primarily for multipurpose facilities such as city buildings. For bonding and bidding purposes, EMI is required to present audited financial statements on the percentage-of-completion basis. For tax purposes, EMI qualifies as a small contractor and continues to use the completed-contract method of accounting, which the company first adopted at its inception in 1984 as its tax method of accounting. Other key assumptions about EMI are as follows:

a. EMI's preliminary December 31, 20X1 book balance sheet is presented in Exhibit 2-2 and its preliminary pretax income for the year ended December 31, 20X1 is presented in Exhibit 2-3.

b. A summary of EMI's construction activities for 20X1 is presented in Exhibit 2-4. EMI completed three contracts in 20X1 (see Exhibit 2-5) and started one contract in 20X1 that was still in progress at December 31, 20X1 (see Exhibit 2-6).

c. For 20X1, unallocated indirect construction costs totaled $230,000 and production period interest of $10,000 was not properly capitalized. Both the unallocated costs and the production period interest should be allocated to contracts, and EMI has consistently allocated such costs based on current year direct contract costs. See the allocation calculations at Exhibit 2-7. (Production period interest for 20X0 was $0.)

d. In preparing the 20X1 Federal income tax return, EMI's CPA noted $2,000 of nondeductible meals included in general and administrative expenses.

e. For 20X1, EMI was required to calculate AMT because the small business exemption from AMT did not apply. The 20X1 AMT depreciation adjustment is $15,000, and the ACE depreciation adjustment is $8,000. Exhibit 2-10 shows the AMT calculations.

f. In 20X0, $225,000 of gross profit was recognized for contracts in progress for book purposes, and $27,000 of indirect costs were capitalized to contracts in progress for book and tax purposes.

g. Exhibit 2-9 presents the calculation of 20X1 taxable income and regular income tax, and Exhibit 2-10 presents the 20X1 AMT calculation.

h. Because EMI uses the completed-contract method for tax purposes, no look-back calculation is required for regular tax. However, for AMT purposes, a look-back calculation is required. Exhibit 2-11 presents the look-back interest calculation for the 20X0 tax year, assuming an 8% interest rate throughout the entire period. AMTI per the 20X0 return as filed was $238,000.

Exhibit 2-2

Electric Man, Inc.
Balance Sheet

December 31, 20X1

ASSETS		
CURRENT ASSETS		
Cash	$	86,000
Receivables:		
Contracts		770,000
Retentions		190,000
Total receivables		960,000
Costs and estimated earnings in excess of billings on uncompleted contracts		25,000
Prepaid expenses and deposits		20,000
TOTAL CURRENT ASSETS		1,091,000
PROPERTY AND EQUIPMENT		
Leasehold improvements		286,000
Construction equipment		49,000
Automotive equipment		337,000
Office furniture and equipment		97,000
		769,000
Less accumulated depreciation		(264,000)
Net property and equipment		505,000
	$	1,596,000
LIABILITIES AND STOCKHOLDER'S EQUITY		
CURRENT LIABILITIES		
Trade accounts payable	$	635,000
Accrued expenses		126,000
Current maturity of long-term debt		57,000
Deferred income taxes		75,000
TOTAL CURRENT LIABILITIES		893,000
LONG-TERM LIABILITIES		
Long-term debt, net of current maturity		59,000
Deferred income taxes		9,000
Total long-term liabilities		68,000
STOCKHOLDER'S EQUITY		
Common stock, no par value, 25,000 shares authorized, 10,000 shares issued and outstanding		10,000
Retained earnings		625,000
		635,000
	$	1,596,000

* * *

Exhibit 2-3

Electric Man, Inc.
Pretax Income

Year Ended December 31, 20X1

Contract revenues earned		$ 3,738,000
CONTRACT COSTS		
Labor and payroll taxes		1,158,000
Materials		1,845,000
Equipment and small tools		140,000
		3,143,000
	GROSS PROFIT	595,000
General and administrative expenses		483,000
		112,000
Interest income		4,000
	PRETAX INCOME	$ 116,000

* * *

Exhibit 2-4

Electric Man, Inc.
Contract Summary

Year Ended December 31, 20X1

	Contract Revenue	Contract Costs	Gross Profit
Contracts completed (Exhibit 2-5)	$ 2,613,000	$ 2,088,000	$ 525,000
Contract in progress (Exhibit 2-6)	1,125,000	825,000	300,000
Unapplied indirect costs	—	230,000	(230,000)
	$ 3,738,000	$ 3,143,000	$ 595,000

* * *

Exhibit 2-5

Electric Man, Inc.
Contracts Completed

Year Ended December 31, 20X1

Job No.	Job Description	Contract Revenue	Direct Costs	Gross Profit		
				Total	Prior Year	Current Year
100	City Hall	$ 2,000,000	$ 1,600,000	$ 400,000	$ 150,000	$ 250,000
120	Medical Center	1,450,000	1,400,000	50,000	75,000	(25,000)
140	Convention Center	1,200,000	900,000	300,000	—	300,000
		4,650,000	3,900,000	750,000	$ 225,000	$ 525,000
	Revenue and costs recognized in prior year	2,037,000	1,812,000	225,000		
	Current year	$ 2,613,000	$ 2,088,000	$ 525,000		

* * *

Exhibit 2-6

Electric Man, Inc.
Contract in Progress

December 31, 20X1

Job No. 130 (Museum)

Total estimated contract	$ 1,500,000
Total estimated cost	1,100,000
Estimated gross profit	400,000
Estimated cost to complete	275,000
Percent complete at 12/31/X1	75 %
Billings to date	1,100,000
Under billings	25,000
Contract revenue to date	1,125,000
Direct contract costs to date	825,000
Total gross profit to date	300,000

* * *

Exhibit 2-7

Electric Man, Inc.
Allocation of Construction Period Interest and Indirect Contract Costs

Year Ended December 31, 20X1

	#100	#120	#130	#140	Total
1. Current year direct contract costs (Exhibit 2-8)	$ 800,000	$ 388,000	$ 825,000	$ 900,000	$ 2,913,000
2. % of total	28 %	13 %	28 %	31 %	100 %
3. Allocation of interest expense to contracts based on line 2 (rounded to thousands)	$ 3,000	$ 1,000	$ 3,000	$ 3,000	$ 10,000
4. Allocation of indirect contract costs to contracts based on line 2 (rounded to thousands)	$ 64,000	$ 30,000	$ 65,000	$ 71,000	$ 230,000
	*	*	*		

Exhibit 2-8

Electric Man, Inc.
Adjusted Schedule of Contract Activity

December 31, 20X1

	Contracts				
Description	100 City Hall	120 Med. Center	130 Museum	140 Convention Center	Total
Commencement date	3-1-X0	9-1-X0	8-1-X1	3-1-X1	
Completion date	3-31-X1	8-31-X1	(in process)	11-30-X1	
Original contract price	$ 1,900,000	$ 1,450,000	$ 1,500,000	$ 1,200,000	$ 6,050,000
Change orders since inception	100,000	—	—	—	100,000
Adjusted contract price	2,000,000	1,450,000	1,500,000	1,200,000	6,150,000
Original total cost estimate	1,600,000	1,350,000	1,100,000	900,000	4,950,000
Additional costs	—	50,000	—	—	50,000
Total estimated costs including change orders	1,600,000	1,400,000	1,100,000	900,000	5,000,000
Estimated gross profit at completion	400,000	50,000	400,000	300,000	1,150,000
Prior year billings	1,200,000	1,000,000	—	—	2,200,000
Current year billings	800,000	450,000	1,100,000	1,200,000	3,550,000

Description	Contracts 100 City Hall	120 Med. Center	130 Museum	140 Convention Center	Total
Total billings since inception	2,000,000	1,450,000	1,100,000	1,200,000	5,750,000
Prior year direct costs	800,000	1,012,000	—	—	1,812,000
Prior year indirect costs	12,000	15,000	—	—	27,000
Adjusted prior year costs	812,000	1,027,000	—	—	1,839,000
Current year direct costs	800,000	388,000	825,000	900,000	2,913,000
Capitalized interest	3,000	1,000	3,000	3,000	10,000
Capitalized indirect costs	64,000	30,000	65,000	71,000	230,000
Adjusted current costs	867,000	419,000	893,000	974,000	3,153,000
Total costs since inception	$ 1,679,000	$ 1,446,000	$ 893,000	$ 974,000	$ 4,992,000

* * *

Exhibit 2-9

Electric Man, Inc.
Computation of Taxable Income

December 31, 20X1

Pretax income (Exhibit 2-3)		$ 116,000	
Add:			
Nondeductible meals		2,000	
20X0 gross profit on contracts in progress (Exhibit 2-5)		225,000	(1)
20X1 capitalized interest on contract in progress (Exhibit 2-7)		3,000	(1)
20X1 capitalized indirect costs on contract in progress (Exhibit 2-7)		65,000	(1)
Less:			
20X1 gross profit on contract in progress (Exhibit 2-6)		(300,000)	(1)
20X0 capitalized indirect costs on contracts in progress (Exhibit 2-8)		(27,000)	(1)
Taxable income		$ 84,000	
Tax			
0–50,000	@ 15%	$ 7,500	
50,001–75,000	@ 25%	6,250	
75,001–84,000	@ 34%	3,060	
		$ 16,810	

Note: The sum of the (1)s, $34,000, represents the AMT adjustment for long-term contracts. See Exhibit 2-10.

* * *

Exhibit 2-10

AMT Calculation for Electric Man, Inc.

Year Ended December 31, 20X1

Taxable income (from Exhibit 2-9)		$ 84,000
Adjustments and preferences:		
AMT depreciation adjustment	$ 15,000	
Long-term contracts (from Exhibit 2-9)	34,000	
		49,000
		133,000
ACE adjustments—depreciation	8,000	
Multiply by 75%	× 75 %	
		6,000
Alternative minimum taxable income		139,000
Less exemption		(40,000)
		99,000
Multiply by 20%		× 20 %
Tentative minimum tax		19,800
Regular income tax (from Exhibit 2-9)		(16,810)
Alternative minimum tax		$ 2,990

* * *

Exhibit 2-11

Electric Man, Inc.
Interest Computation under the Look-back Method (AMT)

For AMTI Reported for the Year Ended December 31, 20X0

Alternative minimum taxable income (AMTI), as reported, December 31, 20X0	$ 238,000
Difference between estimated income on long term contracts, as reported, and actual based on actual contract revenue and costs (from Exhibit 2-12)	(66,917)
Adjusted AMTI for look-back purposes	$ 171,083
AMT on adjusted AMTI, using 20X0 rates (see table below)	27,271
Less tax, as reported on prior return (see table below)	44,000
Decrease in tax over the prior year, for which interest should be refunded	(16,729)
Interest at 8%, compounded daily for one year[a]	$ 1,393

Note:

[a] Since the change in tax exceeds $10,000, there would be two separate interest calculations: (a) interest on the initial $10,000 and (b) interest on the balance of tax. This two-step calculation is not shown in this example and an assumed interest rate of 8% is applied.

AMT Calculation

	Adjusted	As Reported
AMTI	$ 171,083	$ 238,000
Less:		
Exemption before reduction	40,000	40,000
Less 25% of excess of AMTI over $150,000	(5,571)	(22,000)
	34,729	18,000
Net	136,354	220,000
Multiply by 20%	20 %	20 %
AMT	$ 27,271	$ 44,000

* * *

Exhibit 2-12

Electric Man, Inc.
Computation of Look-back Gross Profit

December 31, 20X1

Line No.	Description	Computation	Contracts		Total
	Contract No.		#100	#120	
	20X0				
1	Contract price		$ 1,900,000	$ 1,450,000	$ 3,350,000
2	Estimated total costs		1,600,000	1,350,000	2,950,000
3	Total gross profit	1 − 2	300,000	100,000	400,000
4	Actual costs		812,000	1,027,000	1,839,000
5	20X0 gross profit		150,000	75,000	225,000
	20X1				
6	Revised contract price		2,000,000	1,450,000	3,450,000
7	Estimated total costs		1,679,000	1,446,000	3,125,000
8	Revised gross profit	6 − 7	321,000	4,000	325,000
9	Actual costs during 20X1		867,000	419,000	1,286,000
10	Actual cumulative costs		1,679,000	1,446,000	3,125,000
11	Cost-to-cost % complete	10 ÷ 7	100.00 %	100.00 %	
12	20X1 cumulative gross profit	11 × 8	321,000	4,000	325,000
13	20X1 gross profit (loss)	12 − 5	168,750	(72,074)	96,676
14	20X0 look-back % complete—actual (rounded)	4 ÷ 7	48.36 %	71.02 %	
15	20X0 look-back gross profit	14 × 8	155,242	2,841	158,083
16	20X0 gross profit (over) understated	15 − 5	$ 5,242	$ (72,159)	$ (66,917)

Note: The 20X0 and 20X1 data came from Exhibit 2-8. Contract #140 is not included in the look-back calculations because it was not in process at 12/31/X0.

* * *

Summary

As illustrated in Exhibit 2-9, EMI's 20X1 regular Federal income tax was $16,810; however, the company owed an additional $2,990 for AMT, as illustrated in Exhibit 2-10. The look-back calculation resulted in look-back interest of $1,393 being refundable to EMI for the 20X0 taxable year from the differences between estimated and actual gross profit on Contracts Nos. 100 and 120 for AMT purposes.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Lumber Inc., a C corporation, builds production facilities for a local business. Lumber Inc. qualifies for the small contractor exemption under Code Section 460. They had the following information related to taxable income for 20X2. Please refer to Exhibit 1-1 in Lesson 1 for tax table.

Pretax income	$	125,000
Nondeductible meals	$	3,500
20X2 gross profit on contracts in progress	$	24,500

Compute Lumber Inc.'s 20X2 tax liability.

a. $21,230.

b. $23,810.

c. $40,190.

d. $42,920.

Buildit Co. had the following information related to their AMT calculation for 20X2. Use for questions 33-34.

Buildit Co.
AMT Calculation
Year ended December 31, 20X2

Taxable income	$	73,000
Adjustments and preferences:		
AMT depreciation adjustment	$	20,000
Long-term contracts	$	25,000
Alternative minimum taxable income	$	118,000
Exemption		?
Tentative minimum tax		?
Regular income tax		?
Alternative minimum tax		?

33. After calculating AMTI, Buildit Co.'s accountants had a difficult time determining the exemption amount as well as the tentative minimum tax. Compute Buildit Co.'s tentative minimum tax.

a. $13,250.

b. $15,600.

c. $23,600.

34. Based on the information given, what amount would Buildit Co. record for alternative minimum tax?

a. $0.

b. $2,350.

c. $15,600.

35. ABC Construction had the following information related to the computation of look-back gross profit for 20X1.

Contract price	$ 1,500,000
Estimated total costs	1,250,000
Total gross profit	250,000
Actual costs	634,000
20X0 gross profit	105,000
Revised contract price	1,750,000
Estimated total costs	1,300,000
Revised gross profit	450,000
Actual costs during 20X1	666,000
Actual cumulative costs	1,300,000
Cost-to-cost % complete	100%
20X1 cumulative gross profit	450,000
20X1 gross profit	345,000
20X0 look-back % complete- actual (rounded)	48.77%
20X0 look-back gross profit	219,465
20X0 gross profit over/understated	X

What amount should be recorded as ABC Construction's 20X0 gross profit after applying the look-back procedures?

a. $114,465 understated.

b. $125,535 overstated.

c. $230,535 overstated.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

32. Lumber Inc., a C corporation, builds production facilities for a local business. Lumber Inc. qualifies for the small contractor exemption under Code Section 460. They had the following information related to taxable income for 20X2. Please refer to Exhibit 1-1 in Lesson 1 for tax table.

Pretax income	$	125,000
Nondeductible meals	$	3,500
20X2 gross profit on contracts in progress	$	24,500

Compute Lumber Inc.'s 20X2 tax liability. **(Page 210)**

a. $21,230. [This answer is incorrect. This answer computed the tax liability based on the incorrect taxable income of $97,000 which incorrectly deducted both nondeductible meals and 20X2 gross profit on contracts in progress.]

b. $23,810. [This answer is correct. The tax liability of $23,810 is computed based on taxable income of $104,000. The nondeductible meals must be added back, while the gross profit on contracts in progress are subtracted. ($104,000 − $100,000) × 39%) +$22,250) = $23,810.]

c. $40,190. [This answer is incorrect. Nondeductible meals should not be deducted and 20X2 gross profit on contracts in progress should not be added to arrive at taxable income.]

d. $42,920. [This answer is incorrect. This answer incorrectly computed taxable income by adding both nondeductible meals and 20X2 gross profit on contracts in progress.]

33. After calculating AMTI, Buildit Co.'s accountants had a difficult time determining the exemption amount as well as the tentative minimum tax. Compute Buildit Co.'s tentative minimum tax. **(Page 211)**

a. $13,250. [This answer is incorrect. This amount represents the regular tax Buildit Co. would recognize if no AMT amount applies.]

b. $15,600. [This answer is correct. Because Buildit Co.'s AMTI is less than $150,000 they receive the full $40,000 exemption reducing the amount to $78,000. The $78,000 is then multiplied by 20%.]

c. $23,600. [This answer is incorrect. Had Buildit Co. not been eligible for the exemption this amount would have been correct.]

34. Based on the information given, what amount would Buildit Co. record for alternative minimum tax? **(Page 211)**

a. $0. [This answer is incorrect. Because Buildit Co.'s tentative minimum tax is greater than their computed regular tax, they will have to record an AMT amount.]

b. $2,350. [This answer is correct. Buildit Co.'s tentative minimum tax was greater than their regular tax by $2,350; this amount will be recorded as Buildit Co.'s AMT amount.]

c. $15,600. [This answer is incorrect. This amount represents Buildit Co.'s tentative minimum tax. The tentative minimum tax does not represent the AMT amount.]

35. ABC Construction had the following information related to the computation of look-back gross profit for 20X1.

Contract price	$ 1,500,000
Estimated total costs	1,250,000
Total gross profit	250,000
Actual costs	634,000
20X0 gross profit	105,000
Revised contract price	1,750,000
Estimated total costs	1,300,000
Revised gross profit	450,000
Actual costs during 20X1	666,000
Actual cumulative costs	1,300,000
Cost-to-cost % complete	100%
20X1 cumulative gross profit	450,000
20X1 gross profit	345,000
20X0 look-back % complete- actual (rounded)	48.77%
20X0 look-back gross profit	219,465
20X0 gross profit over/understated	X

What amount should be recorded as ABC Construction's 20X0 gross profit after applying the look-back procedures? **(Page 211)**

a. $114,465 understated. [This answer is correct. 20X0 gross profit after applying look-back procedures equals 20X0 look-back gross profit minus 20X0 gross profit. This amount was understated by $114,465.]

b. $125,535 overstated. [This answer is incorrect. This answer incorrectly subtracts the 20X1 gross profit from the 20X0 look-back gross profit.]

c. $230,535 overstated. [This answer is incorrect. This amount incorrectly subtracts the 20X1 cumulative gross profit from the 20X0 look-back gross profit.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (CONTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

23. Which of the following is an example of a temporary difference?

    a. Inflation adjustments.

    b. Dividends received deduction.

    c. Premiums on officers' life insurance.

    d. Tax exempt interest on municipal bonds.

24. What type of temporary difference occurs when some general and administrative expenses are required to be included in contract costs for tax purposes but not for GAAP?

    a. Differences caused by loss accruals.

    b. Differences in depreciation methods.

    c. Differences in computing percentage of completion.

    d. Differences in accounting for investments in joint ventures.

25. Assuming the effect of the graduated rate structure is not significant, what rate would contractors that expect taxable income to be less than $10 million in the year deferred tax amounts are reported be?

    a. 33%.

    b. 34%.

    c. 35%.

    d. 36%.

26. Strongarm Construction Co. expects to have taxable income for 20X1 of $22 million. In 20X1 they have deductible differences of $93,000 (current) and taxable differences of $75,000 (current). They have no carryforwards and there is no significant negative evidence as to the need for a valuation allowance. How should their deferred taxes be presented?

    a. $5,940 current asset.

    b. $6,120 current asset.

    c. $6,300 current asset.

    d. $6,480 current asset.

27. Which of the following construction activities would **not** be included in domestic production gross receipts (DPGR)?

    a. Hauling debris.

    b. Constructing roads.

    c. Erecting power lines.

    d. Building communication facilities.

28. Gross receipts for the purpose of the domestic production activities deduction include which of the following?

    a. Costs of sales.

    b. Sale of equipment.

    c. Cost of business property sold.

    d. Receipts received from property leased to a related party.

29. The IRC Sec. 199 deduction can be claimed by which of the following business entities?

    a. Partnerships.

    b. S corporations.

    c. C corporations.

    d. Limited Liability Companies.

30. Which of the following is an example of a constructive completion transaction?

    a. A transfer of a partnership interest.

    b. A contribution to a partnership in a IRC Sec. 721(a) transaction.

    c. A distribution from a partnership to which IRC Sec. 731 applies.

    d. Distribution of a contract by a partnership accounted for using a long-term method of accounting.

31. At what rate is the built-in gains tax levied at the corporate level?

    a. 15%.

    b. 25%.

    c. 34%.

    d. 35%.

32. Concrete Co. builds local shops around town. Concrete Co. qualifies for the small contractor exemption under Code Section 460. They had the following information related to taxable income for 20X3. Refer to Exhibit 1-1 in Lesson 1 for the tax table.

Pretax income	$	110,000
20X3 capitalized interest on contract in progress	$	20,000
20X2 capitalized indirect costs on contracts in progress	$	35,000

    Compute Concrete Co.'s 20X3 tax liability.

    a. $8,750.

    b. $18,750.

    c. $20,550.

    d. $47,600.

Busy Bees had the following information related to the AMT calculation for 20X3. Use for questions 33–34.

Buildit Co.
AMT Calculation
Year ended December 31, 20X3

Taxable income	$ 92,000
Adjustments and preferences:	
AMT depreciation adjustment	$ 28,000
Long-term contracts	$ 36,000
Alternative minimum taxable income	$ 156,000
Exemption	?
Tentative minimum tax	?
Regular income tax	?
Alternative minimum tax	?

33. After calculating AMTI, Busy Bees' accountants had a difficult time determining the exemption amount as well as the tentative minimum tax. Compute Busy Bees' tentative minimum tax.

    a. $19,530.

    b. $23,200.

    c. $23,500.

    d. $31,200.

34. Based on the information given, what amount would Busy Bees record as their alternative minimum tax?

    a. $0.

    b. $3,670.

    c. $3,970.

    d. $11,670.

35. BID Construction had the following information related to their computation of look-back gross profit for 20X3.

Contract price	$ 1,200,000
Estimated total costs	1,100,000
Total gross profit	100,000
Actual costs	980,000
20X2 gross profit	95,000
Revised contract price	1,200,000
Estimated total costs	1,175,000
Revised gross profit	25,000
Actual costs during 20X3	195,000
Actual cumulative costs	1,175,000
Cost-to-cost % complete	100%
20X3 cumulative gross profit	25,000
20X3 gross profit	(70,000)
20X2 look-back % complete- actual (rounded)	83.4%
20X2 look-back gross profit	20,850
20X2 gross profit over/understated	X

What amount should be recorded as BID Construction's 20X2 gross profit after applying the look-back procedures?

a. $4,150 overstated.

b. $49,150 understated.

c. $74,150 overstated.

d. $74,150 understated.

GLOSSARY

Accrual method of accounting: The accrual method of accounting is one of the two most common methods of accounting, the other being the cash method. Under the accrual method of accounting, income is reported in the tax year earned, whether or not received, and deductions are claimed in the tax year incurred, whether or not paid.

Alternative Minimum Tax (AMT)*:* The alternative minimum tax (AMT) is designed to prevent taxpayers from escaping a fair share of tax liability by excessive use of certain tax breaks. A taxpayer is subject to AMT if the taxpayer has certain minimum tax adjustments or tax preference items and the alternative minimum taxable income (including adjustment for any net operating loss) exceeds the exemption allowed for the taxpayer's filing status and income level. The AMT is computed on Form 6251 for individuals and Form 4626 for corporations.

Alternative minimum taxable income: The alternative minimum taxable income (AMTI) is used to arrive at the alternative minimum tax (AMT). Generally, AMTI starts with the taxpayer's taxable income. To this amount, the taxpayer adds preference items, adds or subtracts adjustments, and subtracts any alternative minimum tax net operating loss (AMTNOL) deduction to arrive at AMTI.

Built-in gains: Built-in gain or loss is the difference between the fair market value of an asset at the date of transfer to an entity and the adjusted basis of the property in the hands of the transferor. Built-in gain/loss property sold by the transferee within certain time periods may result in tax consequences to the original transferor.

Capitalization of interest: Capitalization of interest is to record the cost of interest (as well as other time-related costs, such as taxes and insurance) paid to finance a long-term construction project (whether self-constructed or acquired from others and whether for self-use or for resale) as an asset and defer its recognition as an expense to future periods. It is not to exceed the total interest incurred during that period.

Conceptually, the amount of interest to be capitalized is the interest that could have been avoided if the expenditures for the asset had not been made. It requires determination of average accumulated expenditures during each interim capitalization period and the capitalization rate (usually the purchaser's incremental borrowing rate or a weighted-average interest rate).

Cash method of accounting: The cash method of accounting is one of the two most common methods of accounting, the other being the accrual method. Under the cash method of accounting, income is reported in the tax year actually or constructively received and expenses are deducted in the tax year paid.

Completed-contract method: The completed-contract method is a method of accounting for long-term contracts under which income is recognized only in the year of completion. Costs in process and billings are accumulated and netted and recorded as an asset (costs in excess of billings) or as a liability (similar to deferred revenue, billings in excess of costs) with no interim charges to revenue (except for provisions for loss, recorded upon discovery). The advantage is that accounting amounts are based on actual results, not estimates. The disadvantage is irregular recognition of income.

If at any time a loss on the project is projected, this loss should be recognized immediately.

This method should be used when a lack of dependable estimates or inherent hazards cause forecasts to be doubtful. Compare to percentage-of-completion method.

In tax accounting: The completed-contract method is an accounting method of recognizing net profit from a long-term contract in the year the contract is completed. With this method, contract costs are deductible in the year that the contract is completed and period costs are deductible in the year paid. Allocations of period and contract costs are outlined in IRS regulations.

Deferred Income Tax: The amount of future tax expense which is computed independently and does not yet appear on the tax return; the net change during the period in the entity's deferred tax liability (asset); results from changes in the deferred (noncurrent) tax liability(asset) which appears on the statement of financial position until it reverses or is settled; is added to the current tax expense (computed on the tax return) to give the total tax expense for the period (a residual amount) which is reported on the income statement.

Home construction contracts: The requirement to use the percentage-of-completion method of accounting applies to all long-term contracts of the taxpayer for AMT, except for certain home construction contracts where the buildings contain four or fewer dwelling units. IRC §§56(a)(3) and 460(e)(6)

In essence, the accounting method used for regular tax purposes by taxpayers to report income on home construction contracts will be allowed for AMT purposes, thereby resulting in no AMT adjustment with respect to home construction contracts.

Long-term contracts: A long-term contract is a contract for the construction of a specific project over an extended period of time (more than one accounting period), such as ships, airplanes, bridges, roads, buildings. Accounting issues include revenue/profit recognition and valuation of construction-in-process. There are two alternative GAAP methods available—completed-contract and percentage-of-completion.

Percentage-of-completion method: Percentage-of-completion is a method of accounting for long-term contracts under which income is recognized as work on the contract progresses (i.e., an estimated amount of income is recognized each accounting period in relation to the percentage of construction that has been completed to date). Recognized income (profit) is that percentage of total expected profit (contract price minus estimated total costs) that corresponds to the percentage of costs incurred to date to total estimated costs, or that corresponds to some other measure of the progress toward completion, giving due regard to the work performed to date (some engineering measure of the percentage of work completed).

Assets under this method may include accumulated costs (construction-in-progress) and recognized income in excess of billings. Liabilities may include billings in excess of costs and recognized income.

Data used to compute the amount of income to be recognized includes the following:

- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.The contract price
- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.Actual costs to date
- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.Income already recognized
- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.Estimated total costs to complete the project

If at any time a loss on the project is projected, this loss should be recognized immediately. Recognized income is "reversed" and the remaining loss is recognized.

Permanent Differences: Permanent differences are differences between accounting income and taxable income that are not expected to reverse. These are amounts that arise as a result of transactions or events recognized in the financial statements that do not have any tax consequences or vice versa (items that have a tax consequence but are not determinants of accounting income or have no effect on interperiod tax allocation). Tax payable in the current period equals the income tax expense that arises from the item.

Example: Items that result in permanent differences include the following:

- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.Tax-free interest (on municipal bonds), insurance expense for premiums paid on officers' life insurance, and compensation expense on ESOPs (i.e., income or expenses that are determinates of accounting income but have no tax effect—not reported on the tax return)
- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.Income exclusion for corporate dividends received and the excess statutory depletion over cost depletion (i.e., items that are *not* recognized in accounting income but do have tax consequences)

Personal property: Personal property is everything that is the subject of ownership that is not real property. It is also known as movables and chattels. Personal property can be either corporeal or incorporeal:

- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties. Corporeal property is tangible property or things in possession, such as furniture, equipment, and cattle.

- Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties. Incorporeal property is intangible property or things in action, such as stocks, bonds, accounts, patents, and royalties.

Real property may be converted into personal property by severance (removal from the land, such as with sand or a growing tree). Personal property may be converted into realty by attachment (e.g., used in the construction of structures like buildings, roads, fences, or bridges, such as with cement, bricks, lumber, or a central air-conditioning and heating system).

Real property: Real property (also known as *real estate*) includes land, buildings, and their structural components.

Temporary Differences: Temporary differences are amounts that arise from items that are treated differently under GAAP than under the tax law, and that are expected to reverse (create an offsetting amount) in the future, such as installment sales, warranty expense, and depreciation under different methods.

Note: "Timing" difference is no longer acceptable terminology.

Temporary differences result from an attempt to match the income tax expense with the transaction that caused the related income tax consequence. Allocation is necessary because some of these income tax consequences are reported for financial reporting purposes and for income tax purposes in different accounting periods (i.e., financial accounting standards and the tax law differ in *when* certain revenues and expenses are recognized, hence when the tax effect is recognized).

Temporary differences are the difference between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount is recovered or settled. Characteristics of temporary differences follow:

- They are recognized in *both* accounting income and taxable income.

- They give rise to deferred income tax liability (due to differences in the timing of the recognition).

- They reverse in one or more future periods.

Valuation allowance: A valuation allowance is a "contra" account. It may have a debit balance or a credit balance, depending on the circumstances. It is neither an asset nor a liability itself; rather, it is used to reflect the difference between the amount at which a given asset or liability must be recognized in the entity's financial statements. For example, an entity may choose to record its marketable equity securities in its books at acquisition cost. GAAP, however, require those securities to be recognized in the entity's financial statements at fair value. A valuation allowance account could be used to reflect the difference between the acquisition cost and the fair value of those securities.

In the case of income taxes, a valuation allowance account is used to show the portion of a deferred tax asset that an entity does not expect to be realized. Its use allows the entity to keep the deferred tax asset in its books at the amount that would be realized if all of it were to be realized but recognize in the balance sheet the amount that is expected to be realized.

INDEX

A

ALTERNATIVE MINIMUM TAX
- ACE adjustment 121
- AMT credit 123
- Exemption for small corporations 121
- Form 4626 120
- Formula for computing AMT 120
- General considerations 120
- Illustration of AMT computation 121
- Losses 123
- Percentage-of-completion method is required 121
- S corporations and partnerships 123

C

COMPLETED-CONTRACT METHOD—GAAP
- Sale or other disposition of uncompleted contracts 197

D

DEFERRED TAXES
- Calculation illustrated 185
- Calculation of deferred tax 183
- Classification on balance sheet 185
- Deductible differences 182
- Overview 181
- Permanent differences 181
- Taxable differences 182
- Tax rates to use 183
- Temporary differences 181
- Temporary differences unique to contractors 182
- Valuation allowance 184

F

FINANCIAL STATEMENTS
- Classified balance sheet—deferred taxes 185

L

LOOK-BACK
- Calculation of over/under statement 134
- Change orders 132
- Claims 132
- Contingencies 132
- Deferral of income under the 10% method 131
- Delayed application rule 132
- *De minimis* (small contract) exception 130, 131
- Discounting of cash received and paid 132
- Form 8697 134
- General guidance 130
- Illustration 133, 134
- Illustration for small contractor 205
- Interest calculation 134
- Performance bonus 132
- Post-completion revenue and expense 132, 135
- Redetermination of prior year gross profit 133
- Simplified look-back for pass-through entities 131
- Taxability of refund/expense 145

LOSS PROVISIONS
- Taxation of losses 183

Q

QUALIFIED PRODUCTION ACTIVITIES 190

S

SAMPLING—See AUDIT SAMPLING

S CORPORATIONS
- Built-in gains—conversion from C to S corporation 199

SMALL CONTRACTOR'S EXEMPTION
- Case study 205

T

TAX ACCOUNTING METHODS FOR CONTRACTORS
- Completed-contract method 197
- Electing an accounting method 197
- Employee vs. independent contractor 200

U

U.S. CORPORATION INCOME TAX RETURN 147

COMPANION TO PPC'S GUIDE TO CONSTRUCTION CONTRACTORS

COURSE 3

CONSULTING SERVICES (CONTG103)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course provides an overview of general guidance applicable to most consulting services and information on two specific consulting services commonly provided to construction contractors, financing services and claim settlement services.

PUBLICATION/REVISION DATE: July 2010

RECOMMENDED FOR: Users of *PPC's Guide to Construction Contractors*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of construction contractors

CPE CREDIT: 6 QAS Hours, 6 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.

FIELD OF STUDY: Management Advisory Services

EXPIRATION DATE: Postmark by **July 31, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Consulting—General Guidance

Completion of this lesson will enable you to:
- Identify the standards that apply to consulting engagements.
- Recognize the various steps included in consulting engagements.

Lesson 2—Consulting—Financing Services

Completion of this lesson will enable you to:
- Identify financing services and determine the client's financial needs and the types of financing available to fulfill those needs.
- Prepare a financing proposal.
- Identify critical points in negotiating financing.

Lesson 3—Consulting—Claim Settlement Services

Completion of this lesson will enable you to:
- Recognize ways to resolve contractor claims and identify events or conditions that may result in damages.
- Calculate contractor damages.
- Identify engagement activities and administration.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 323-8724 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Consulting—General Guidance

INTRODUCTION

This lesson provides a high-level overview of general guidance that applies to most consulting services, as well as information on two particular consulting services that are commonly provided to construction contractors: financing services and claim settlement services. The lesson focuses on those considerations applicable to construction contractors. However, it is not meant to provide the depth of information that may be required to perform those two or many other consulting services.

The following matters are covered that are relevant to all consulting engagements:

a. Consulting standards.

b. Overview of a small business consulting practice.

c. Engagement initiation and planning.

d. Engagement conduct and control.

e. Engagement review, reporting, and follow-up.

Financing services engagements and claim settlement services are also covered and include aspects of the matters listed above that are specific to financing or claim settlement services.

Advertising Consulting Engagements

If the firm advertises its services, the firm should be aware of the rules and restrictions on advertising in the AICPA *Code of Professional Conduct*, including the ethics interpretation at ET 502.03, which prohibits advertising activities that "create false or unjustified expectations of favorable results" or that "imply the ability to influence any court, tribunal, regulatory agency, or similar body or official." The firm should also be aware of the rules related to advertising imposed by the Federal Trade Commission, the Internal Revenue Service, and the various state boards of public accountancy. All marketing methods and techniques should be reviewed to ensure that they comply with the rules covering advertising.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the standards that apply to consulting engagements.
- Recognize the various steps included in consulting engagements.

CONSULTING STANDARDS

Statements on Standards for Consulting Services are issued by the AICPA Consulting Services Executive Committee, the senior technical body of the AICPA designated to issue pronouncements on consulting services. Those standards provide the overriding guidance for CPA consultants and are discussed in further detail below.

Other standards that may apply to consulting services provided by CPAs, CPA firms, and staff members of CPA firms are essentially the standards of the public accounting profession established by the AICPA. These standards can be classified into the following categories:

a. *Attestation Standards.* Statements on Standards for Attestation Engagements (SSAEs) establish performance and reporting standards applicable when a CPA is engaged to issue or does issue an examination, review, or agreed-upon procedures report on subject matter (or an assertion about the subject matter) that is the responsibility of another party.

b. *Standards on Financial Forecasts and Projections.* Standards on financial forecasts and projections are part of the SSAEs and establish presentation, performance, and reporting standards for consulting engagements that include reporting on a client's prospective financial information.

c. *Standards on Reports on Internal Control over Financial Reporting.* Standards on reports on internal control establish guidance for consulting engagements that include reporting on the effectiveness of a client's internal control over financial reporting.

d. *Standards of Professional Conduct.* The CPA must consider the effect of consulting services on attest engagement independence. The *Code of Professional Conduct* (the Code) of the AICPA and related interpretations and rulings govern the independence and conduct of its members.

e. *Standards for Business Valuation Services.* The standards for business valuation services provide guidance on overall valuation engagement considerations, the development of valuation conclusions, and the clear communication of those conclusions through explicit reporting requirements.

f. *Standards on Reporting on Historical Financial Information.* Standards on reporting on historical financial information are generally relevant when a CPA consultant submits historical financial statements as part of the communication of the results of a consulting engagement. Financial statements are considered "submitted" when the consultant presents to a client or third party statements that are prepared by the CPA consultant. In those situations, the historical financial statements generally should at least be compiled and reported on by the CPA consultant in accordance with the Statements on Standards for Accounting and Review Services (SSARS). There are certain situations in which the CPA consultant is not required to follow SSARS No. 1 and ways to avoid applicability of the sometimes complex SSARS No. 1, including merely reproducing the client's financial statements; presenting condensed or selected financial data in accordance with provisions in SSARS No. 13, *Compilation of Specified Elements, Accounts, or Items of a Financial Statement* (AR 110); or presenting management-use-only financial statements in accordance with SSARS No. 8, *Amendment to Statement of Standards for Accounting and Review Services No. 1, "Compilation and Review of Financial Statements."*

Standards for Consulting Services

Statement on Standards for Consulting Services No. 1 (SSCS No. 1), *Definitions and Standards*, applies to all consulting services, and Rule 202 of the AICPA *Code of Professional Conduct* requires members to comply with the consulting standards. SSCS No. 1 (CS 100.05) defines consulting services as "professional services that employ the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process." SSCS No. 1 groups consulting services into six categories:

a. *Consultations.* Consultations are generally informal oral advice in response to a client question, completed in a short time frame, based mostly, if not entirely, on the practitioner's personal knowledge, and for which the CPA usually is not paid directly. For example, if during lunch, the client asks the practitioner to suggest software to consider in its search for a contract cost accounting system—that is a consultation. Or, the client might ask the practitioner to comment informally on a business plan or to discuss alternatives that exist to obtain financing.

b. *Advisory Services.* Advisory services involve developing findings, conclusions, and recommendations for client consideration and decision making, and they often result in a written report. Examples of advisory services are an operational review and improvement study, or defining requirements for an information system.

c. *Implementation Services.* Implementation services involve putting an action plan or recommendations into effect and may involve client personnel as well as the practitioner and staff. Examples of implementation services are assisting in computer system installation and support, setting up new procedures to implement recommendations from an operational review, and assisting in the implementation of a new incentive compensation system.

d. *Transaction Services.* Transaction services provide the practitioner's written findings and conclusions related to a specific client transaction, generally with a third party. Examples of transaction services are

business valuations, preparing information to obtain financing (but not preparation of historical or prospective financial statements), and claim settlement services.

e. *Staff and Other Support Services.* Staff and other support services occur when the practitioner provides staff and possibly other support services to perform tasks specified by the client. The client directs the staff. Examples include providing staff for computer facilities management and serving as controller.

f. *Product Services.* Product services involve providing a product with associated professional services in support of the installation, use, or maintenance of the product. Examples include sale and delivery of packaged training programs, and sale and implementation of computer software.

Independence and Consulting Services. The AICPA standards do not prohibit consulting services engagements for an entity for which the practitioner is not independent, for example, for a close relative. However, CPA consultants should consider the impact of consulting services on attest engagements that require independence, such as auditing, and whether the consulting services would impair that independence.

General Standards

The following general standards are stated in Rule 201 of the *Code* and apply to all AICPA members:

a. *Professional Competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

b. *Due Professional Care.* Exercise due professional care in the performance of professional services.

c. *Planning and Supervision.* Adequately plan and supervise the performance of professional services.

d. *Sufficient Relevant Data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

SSCS No. 1 adds three additional general standards for consulting services:

a. *Client Interest.* Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.

b. *Understanding with Client.* Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed, and modify the understanding if circumstances require a significant change during the engagement. SSCS No. 1 emphasizes that the CPA's responsibility to the client for a consulting service is defined primarily by the understanding with the client. Ethics Interpretation 101-3 requires written documentation of the understanding with the client when performing nonattest services for an attest client. Although a written understanding with the client is not specifically required for nonattest clients, a documented understanding is strongly suggested. In either oral or written communication, the practitioner should not explicitly or implicitly guarantee results.

c. *Communication with Client.* Inform the client of (1) conflicts of interest that may occur pursuant to interpretations of Rule 102 of the *Code*, (2) significant reservations concerning the scope or benefits of the engagement, and (3) significant engagement findings or events. It is believed that, except for informal consultations, the consultant should provide the client a written communication at the conclusion of an engagement unless the circumstances of the engagement dictate that a written report is inappropriate, such as in certain litigation service engagements.

Quality Control Standards and Peer Review Standards

Consultants may wonder whether the AICPA's quality control standards apply to services performed under the AICPA's Statement on Standards for Consulting Services. The short answer is "no." However, the consultant must consider the requirements of the AICPA's quality control standards if any consulting services include a component to which the AICPA's audit, attestation, or accounting and review standards apply.

Statement of Quality Control Standards No. 7, *A Firm's System of Quality Control,* (QC 10) provides standards and guidance for a CPA firm's responsibilities for its system of quality control. (See section 500 for additional information regarding SQCS No. 7.) QC 10.128 states—

> The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice. . .

The standard defines an accounting and auditing practice as audit, attestation, compilation, review, and other services for which standards have been established by the AICPA Auditing Standards Board (that is, SAS and SSAE) or the Accounting and Review Services Committee (that is, SSARS). Services performed under the AICPA's consulting standards are not covered by the AICPA's quality control standards, but the quality control requirements would apply to the portion of a consulting engagement to which SASs, SSARS or SSAEs apply.

Consultants may also wonder whether the AICPA's peer review requirements apply to services performed under the AICPA's Statement on Standards for Consulting Services. Similar to the quality control requirements discussed previously, the short answer is "no." The *Standards for Performing and Reporting on Peer Reviews*, as revised effective January 1, 2009, (PR 100.03 and PR 100.08) describe the scope of peer review engagements as follows:

> Firms . . .enrolled in the Program have the responsibility to have independent peer reviews of their accounting and auditing practices . . . An *accounting and auditing practice* for the purposes of these Standards is defined as all engagements covered by Statements on Auditing Standards (SASs); Statements on Standards for Accounting and Review Services (SSARS); Statements on Standards for Attestation Engagements (SSAEs); and the Government Auditing Standards (the Yellow Book), issued by the U.S. General Accounting Office (GAO).

Thus, the peer review requirements do not apply to services performed under the AICPA's consulting standards—only to those services qualifying as accounting and audit practice described above except for SSARS No. 8 engagements as discussed above.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The Statements on Standards for Consulting Services provide the overriding guidance for CPA consultants. Read the following example and determine which of the Standards apply.

   a. Statements on Standards for Attestation Engagements.

   b. Standards on Financial Forecasts and Projections.

   c. Standards of Professional Conduct.

   d. Standards for Business Valuation Services.

2. In accordance with the Statement on Standards for Consulting Services No. 1 (SSCS No. 1), *Definitions and Standards*, if during lunch, the client asks the practitioner to suggest software to consider when searching for a contract cost accounting system, such a request would fall under which one of the following categories of consulting services?

   a. Advisory services.

   b. Consultations.

   c. Transaction services.

   d. Product services.

3. The AICPA's peer review requirements apply to which of the following?

   a. All consulting engagements.

   b. Reviews of accounting and auditing standards covered by certain specified AICPA standards, except for SSARS No. 8 engagements.

   c. Aspects of consulting engagements covered by certain specified AICPA standards, except for SSARS No. 13 engagements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. The Statements on Standards for Consulting Services provide the overriding guidance for CPA consultants. Read the following example and determine which of the Standards apply. **(Page 231)**

   Geoffrey is engaged to provide consulting services for General Contractors, Inc. Geoffrey must first acknowledge the outcome of consulting services on attest engagement independence.

   a. Statements on Standards for Attestation Engagements. [This answer is incorrect. Statements on Standards for Attestation Engagements (SSAEs) establish performance and reporting standards applicable when a CPA is engaged to issue or does issue an examination, review, or agreed-upon procedures report on subject matter (or an assertion about the subject matter) that is the responsibility of another party.]

   b. Standards on Financial Forecasts and Projections. [This answer is incorrect. Standards on financial forecasts and projections establish presentation, performance, and reporting standards for consulting engagements that include reporting on a client's prospective financial information.]

   c. Standards of Professional Conduct. [This answer is correct. Geoffrey must consider the effect of consulting services on attest engagement independence. The Code of Professional Conduct (the Code) of the AICPA and related interpretations and rulings govern the independence and conduct of its members.]

   d. Standards for Business Valuation Services. [This answer is incorrect. The standards for business valuation services provide guidance on overall valuation engagement considerations, the development of valuation conclusions, and the clear communication of those conclusions through explicit reporting requirements.]

2. In accordance with the Statement on Standards for Consulting Services No. 1 (SSCS No. 1), *Definitions and Standards*, if during lunch, the client asks the practitioner to suggest software to consider when searching for a contract cost accounting system, such a request would fall under which one of the following categories of consulting services? **(Page 232)**

   a. Advisory services. [This answer is incorrect. Per SSCS No. 1, advisory services involve developing findings, conclusions, and recommendations for client consideration and decision making, and many times result in a written report such as an operational review and improvement study, or defining requirements for an information system.]

   b. Consultations. [This answer is correct. Per SSCS No. 1, consultations are generally informal oral advice in response to a client question (such as during a lunch meeting), completed in a short time frame, based mostly or entirely on the practitioner's personal knowledge, and for which the CPA usually is not paid directly.]

   c. Transaction services. [This answer is incorrect. Per SSCS No. 1, transaction services provide the practitioner's written findings and conclusions related to a specific client transaction, most often with a third party such as business valuations, preparing information to obtain financing, and claim settlement services.]

   d. Product services. [This answer is incorrect. Per SSCS No. 1, product services involve providing a product with associated professional services in support of the installation, use, or maintenance of the product such as sale and delivery of packaged training programs, and sale and implementation of computer software.]

3. The AICPA's peer review requirements apply to which of the following? **(Page 234)**

   a. All consulting engagements. [This answer is incorrect. The AICPA peer review requirements do not apply to all consulting engagements per se, but to certain aspects of most engagements.]

   b. Reviews of accounting and auditing standards covered by certain specified AICPA standards, except for SSARS No. 8 engagements. [This answer is correct. The AICPA's peer review requirements apply only to those services qualifying as accounting and audit practices covered by certain specified AICPA standards, *excluding* SSARS No. 8 engagements.]

   c. Aspects of consulting engagements covered by certain specified AICPA standards, except for SSARS No. 13 engagements. [This answer is incorrect. The AICPA's peer review requirements apply to aspects of consulting engagements covered by certain specified AICPA standards, *including* SSARS No. 13 engagements.]

SMALL BUSINESS CONSULTING PRACTICE OVERVIEW

This lesson introduces the approach to small business consulting engagements that is recommended. The approach is intended to provide a framework for the important activities common to all small business consulting engagements.

Every small business consulting engagement has the following three primary phases:

a. Engagement initiation and planning.

b. Engagement conduct and control.

c. Engagement review, reporting, and follow-up.

Exhibit 1-1 lists generalized forms and other written documentation related to each primary phase of a small business consulting engagement.

Exhibit 1-1

Generalized Forms and Other Documentation for Consulting Engagements

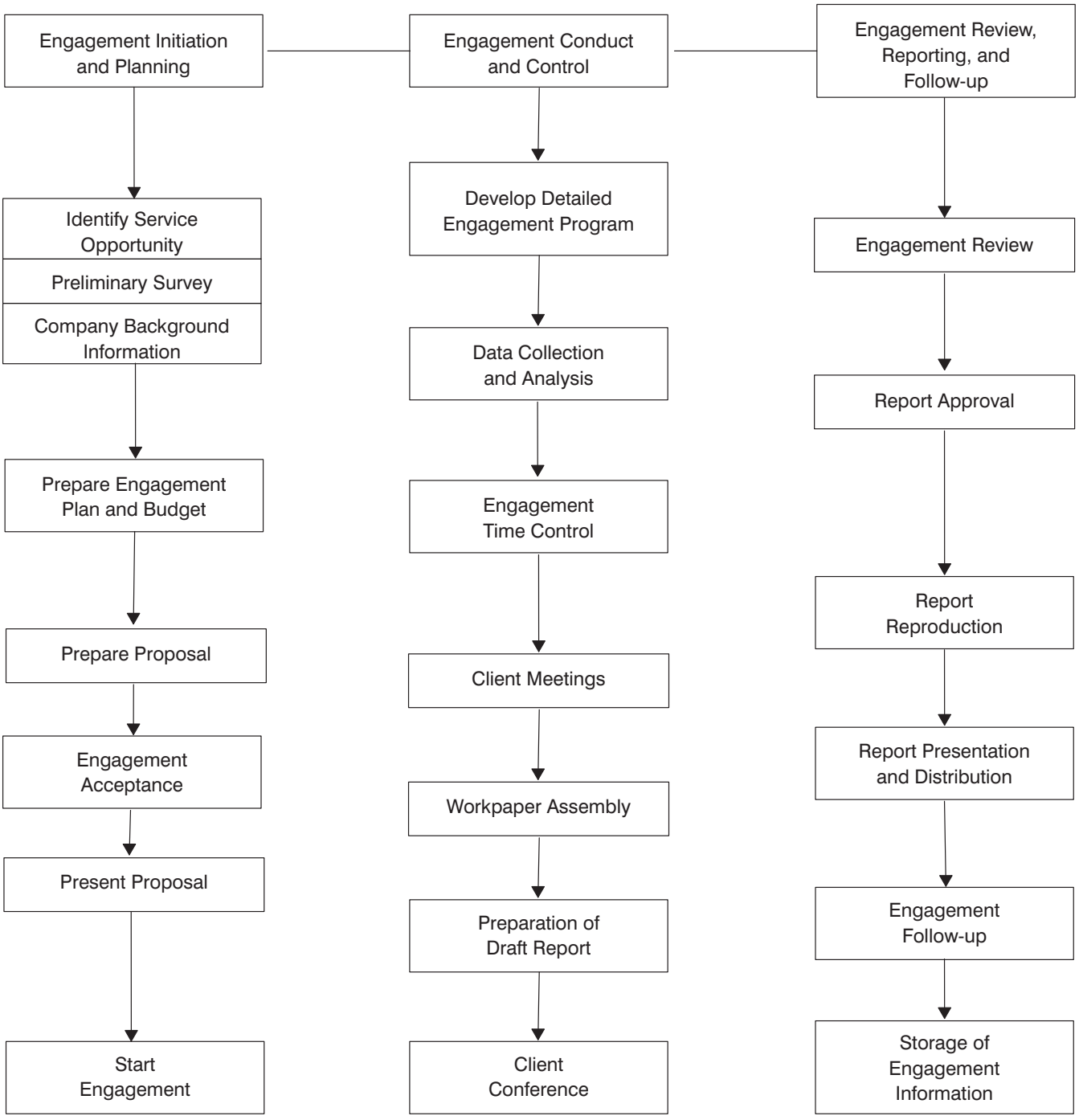
ENGAGEMENT INITIATION AND PLANNING	ENGAGEMENT CONDUCT AND CONTROL	ENGAGEMENT REVIEW, REPORTING, AND FOLLOW-UP
Form or Documentation	**Form or Documentation**	**Form or Documentation**
Engagement Acceptance Form for Construction Contractors	Detailed Engagement Program	Engagement Review Checklist for Construction Contractors
Construction Company Background Information Form	Engagement Time Control—Small Business Consulting	Report Instruction Sheet—Small Business Consulting
Engagement Plan and Budget Form—Small Business Consulting	Data Collection and Ratio Analysis Worksheet	Final Report
Engagement Letters for Construction Contractors	Workpaper Index Checklist—Small Business Consulting	
	Representation Letter for a Construction Contractor Financing Services Engagement	
	Draft Report	

* * *

Exhibit 1-2 presents an overview of these three primary phases. Under each primary phase are the individual work segments in that phase. The following sections highlight the steps in completing a small business consulting engagement.

Exhibit 1-2

Consulting Engagement Overview



* * *

INITIATION AND PLANNING OF AN ENGAGEMENT

As noted in Exhibit 1-2, the engagement initiation and planning phase of a consulting engagement includes the following steps:

a. Identifying the service opportunity.

b. Completing a preliminary survey.

c. Obtaining an understanding of the company.

d. Preparing an engagement plan and budget.

e. Preparing the proposal.

f. Completing engagement acceptance procedures.

g. Presenting the proposal.

h. Starting the engagement.

The above steps are briefly discussed in the remainder of this lesson.

Identifying the Service Opportunity

Most small business consulting engagements begin with a discussion between a representative of the CPA firm and the potential client. The discussion may be initiated by the potential client based on a recognized need for consulting services or by the accounting firm based on identification of a consulting opportunity.

Completing a Preliminary Survey

Often, the client's problems that initiated the discussion about a potential consulting engagement are only symptoms, and some initial work may be necessary to develop a more precise engagement definition. This initial work is often referred to as a preliminary survey. The survey will answer questions about the client's problem and potential solutions. Once answered, the firm should be able to decide if the problem is solvable by consulting skills and techniques and whether the firm possesses the capabilities for the engagement.

One type of preliminary survey addresses basic questions in a limited way but does not attempt exhaustive problem definition. This survey, being severely limited in scope, requires little time and is seldom billed or reported on separately. It usually results only in a proposal letter to the client. Another type of survey is the performance of a brief engagement or the first phase of a potentially long engagement. This is a "diagnostic survey" directed to searching extensively for underlying problems and defining them precisely. At the end of such a survey, a proposal is usually offered to seek and recommend solutions. The consultant may bill for the time required to complete the diagnostic survey. However, many consultants prefer to complete the survey free of charge in the hope that the survey results will highlight one or more consulting opportunities that can then be sold to the client on a fee basis.

The end result of a preliminary survey should be a proposal letter that describes the engagement and is forwarded to the prospective client. Enough information should be gathered in the preliminary survey to develop a proposal that states the scope of the work and the firm's responsibilities in terms sufficiently precise to avoid disagreements. A statement of the objectives of the proposed engagement should include the specific help the client is seeking as well as the correction of more fundamental problems, if these also must be resolved.

Obtaining an Understanding of the Company

As part of a preliminary survey, the consultant will accumulate some information about the potential client. At the preproposal stage, a minimum level of such information will be necessary for the consultant to become familiar with

general aspects of the potential client's operations and the specific area that is the focus of the potential engagement so that a sound proposal can be prepared. The consultant will probably obtain more background data about the company at other stages—when deciding whether to accept the client, when planning a detailed work program after the engagement is accepted, and as part of the data gathering process.

The background of the company gives the consultant a feeling for the characteristics of the organization that might account for the problem or affect the appropriateness of alternative solutions. Company background factors include: ideas, attitudes, and opinions of key management personnel, the company's goals and operating style, why certain employees are where they are, and how the company has grown over the years. Knowledge of these factors will help the consultant understand the current position and future direction of the business. It is essential that a consultant be familiar with the general terms used by, and the regulation required of, the client being served. For example, if the client enters into government contracts, familiarity with the Federal Acquisition Rules, housing and urban development requirements, and the Federal Truth-in-Negotiations Act is critical to the consultant's effectiveness. If the company is an existing client, the background information may already be available in the firm's files.

Preparing an Engagement Plan and Budget

An engagement plan and budget should be completed *before a proposal is submitted to a client* to consider the major tasks needed to quote time and fees (including development activities, supervision, client meetings, report preparation, etc.). However, it does not document all the individual steps necessary to successfully complete the engagement. Thus, a detailed and comprehensive work plan should also be prepared.

Preparing the Proposal

The proposal is based on the information developed during the initial client contact and preliminary planning procedures. Proposals can vary widely between engagements, but each proposal should generally include—

a. A definition of the problem and the expected benefits of the engagement with a proper description of the respective roles of the client and the firm.

b. The proposed engagement plan and approach.

c. An estimate of fees and billing arrangements.

Basic Content of the Proposal. In addition to the definition of the problem and expected benefits, the following specific matters should be covered individually in the proposal:

a. *Scope and Role.* The scope of the engagement and the role to be undertaken by the firm should be clearly stated.

b. *Approach.* This is a general understanding with the client about how the engagement will be carried out (for example, data gathering techniques and the order of activities).

c. *Personnel.* The proposal should specify how both firm and client personnel are to be assigned and organized and what the working relationship between them should be.

d. *Fee Arrangements.* The proposal should specify whether the fee is an estimate based on hourly rates or a flat amount and indicate the frequency of billings and payments. In proposing the fee, the practitioner should be aware that Rule 302 of the *Code* prohibits CPAs from accepting a contingent fee for any service for a client for whom the CPA also performs attest services—that is, audits, reviews, compilation services, or examinations of prospective financial statements. (Compilation services may be provided as long as the accountant's compilation report discloses the lack of independence.) Moreover, many state boards of accountancy prohibit CPAs from accepting contingent fees from a client in all circumstances and from accepting commissions. Practitioners should consult with their state board to determine the current status of the rules relating to commissions and contingent fees.

e. *Firm Qualifications.* To demonstrate the firm's capabilities to perform the engagement, the proposal may also contain descriptions of similar engagements performed.

f. *Deliverables.* The proposal should identify specifically those items that will be delivered to the client as a result of the engagement (for example, a final written report and/or an oral presentation of the report).

g. *Exclusions and Disclaimers.* All proposals should be worded to specifically identify what constitutes the completion of the engagement and clearly exclude matters not included.

Completing Engagement Acceptance Procedures

An overriding consideration in the engagement acceptance decision is a CPA firm's desire to avoid association with a client that has a poor or questionable reputation for honesty or business ethics. For this reason, it is desirable to do a background check on the client using sources such as Dun & Bradstreet, the Better Business Bureau, or other professionals serving the client.

A CPA firm may have an existing engagement acceptance policy and form suitable for accounting, auditing, tax, or consulting services.

Presenting the Proposal

The formal presentation of a proposal to a prospective client can be made orally or in writing (or both). However, a personal approach is preferable, and it is recommended that oral presentations be arranged whenever possible. These presentations provide the client an opportunity to meet the members of the project team, to raise questions concerning the accomplishment of project objectives and, in a preliminary manner, to evaluate the abilities of the firm's representatives. It is also recommended that every engagement be confirmed in writing by a proposal letter or an engagement letter. Written documentation of the understanding is required if the consulting service is for an attest client.

Starting the Engagement

Once the preceding steps are completed and the client accepts the CPA firm's proposal, the engagement team starts the project. The focus then moves to engagement conduct and control.

CONDUCT AND CONTROL OF THE ENGAGEMENT

As noted in Exhibit 1-2, the engagement conduct and control phase of a consulting engagement includes the following steps:

a. Developing detailed engagement program.

b. Collecting data.

c. Analyzing data. For discussion purposes, data collection and data analysis are treated as two steps, even though they are interrelated.

d. Controlling engagement time.

e. Meeting with client.

f. Assembling workpapers.

g. Preparing draft report.

h. Conferring with client.

Developing Detailed Engagement Programs

The detailed engagement program is a planning tool that documents how the engagement is to be carried out, organizes an engagement into a scheduled sequence, and indicates the various tasks that must be accomplished

to obtain the intermediate goals as well as the final product and to comply with relevant professional standards. It is a master plan for the engagement and the framework for controlling its progress.

Matters to Be Covered. A detailed engagement program should include:

a. Pre-engagement planning matters, for example, establishment of an understanding with the client as to the engagement objectives and scope, budget, etc.

b. Various tasks to be performed to achieve the engagement objectives, including:

   (1) personnel to be interviewed,

   (2) study techniques to be used,

   (3) data to be gathered, such as forms, volume counts, input sources, reports received or generated, etc., and

   (4) outside sources to be contacted for information.

c. Reports to be prepared.

d. Engagement review and follow-up.

Each task in the detailed engagement program should be described so an experienced consultant will know precisely what to do. The degree of detail depends on the experience of the consultants assigned and the size and complexity of the engagement. The tasks specified in the work program should include supervision, conferences with the client, preparation of progress reports, and the editing of the final report. Additionally, the consultant should plan for the involvement of client personnel, especially if they are an integral part of the engagement. When developing the detailed engagement program, resources such as computer equipment and software necessary to perform the engagement should also be determined.

Determination of Staffing Requirements. In conjunction with the development of the detailed engagement program and task descriptions, the staffing requirements for the engagement should be determined. Staff assignments depend on the competence level and skills required for the engagement, as well as experience with similar assignments. Client responsibilities should also be determined and cleared with the client executive responsible for liaison.

Collecting Data

The primary methods of data collection in consulting engagements are interviewing clients and gathering and reviewing documents. This discussion concentrates on interviewing skills because CPAs are generally familiar with techniques used to gather and review documents.

Interviewing. During the data collection process of an engagement, the consultant usually conducts interviews. While it is impossible to prescribe specific rules for preparing an interview since an interview should be flexible and fluid, the following interviewing steps have proven to be effective.

a. *Analyze the Other Person.* This is probably the most important step in the preparation process. If you know whom you will be interviewing, consider the person's characteristics. Will the person talk freely, or will the person be reluctant to respond? If you do not know the person, you should still attempt an analysis. What is the person's job? Considering the purpose of the interview, is the person apt to be argumentative, pleasant, or conciliatory? What should the person know about the subject or the problem?

b. *Gain the Interviewee's Confidence before the Interview.* Be clear and professional when requesting the interview. Give ample notice of the time and place.

c. *Plan the Type, Use, and Sequence of Questions.* The main questions should be planned in advance. However, be flexible during the interview. Sometimes, rewording prepared questions better fits the discussion as the interview progresses, while keeping to the main points prepared.

d. *Arrange Comfortable Facilities.*

e. *Prevent Interruptions from Technology.* Turn off electronic devices such as a cellular phone, a BlackBerry, or a pager.

f. *Use the Directive Interviewing Approach for Straight Information Gathering.* In this approach, the interviewer establishes the purpose and controls the direction and pacing of the interview.

g. *Use the Nondirective Interviewing Approach in Problem-solving Situations.* In this approach, the interviewee controls the purpose, direction, and pacing of the interview.

Analyzing Data

Data analysis is the thinking process used by the consultant to develop a logical series of findings, conclusions, and recommendations for a particular consulting engagement. Judgment seasoned by experience is brought to bear on the mass of facts collected to arrive at a satisfactory solution to the client's problems.

The data to be analyzed is obtained from interviewing clients, reviewing documents, researching existing publications, and reviewing industry specialized surveys such as the Construction Financial Management Association financial survey. The consultant's preliminary analysis should be directed to developing several alternative solutions or recommendations that will ultimately be narrowed to a single solution or recommendation to be proposed to the client.

Controlling Engagement Time

Control of time spent on each task of the assignment is necessary to stay within the time budget.

Meeting with Client

Arrangements should be made to conduct regularly scheduled progress meetings with client management. These progress meetings communicate the status of the engagement (such as the major tasks completed and the status of those in progress), create a sense of client involvement, and serve to enlist the support and counsel of client management.

Assembling Workpapers

Objectives of Workpapers. While SSCS No. 1 does not require that the CPA consultant prepare workpapers, their use is encouraged. Well-conceived, properly organized workpapers facilitate the supervision and review of the engagement and contribute to a well-written and complete final report. Additionally, firm policies generally require that workpapers be prepared as an aspect of quality control and for their historical value. If a CPA performs a consulting engagement, a portion of which is covered by SSAE No. 10, *Attestation Standards: Revision and Recodification*, workpapers must be prepared and maintained in accordance with the attestation standards.

Generally, workpapers can be classified into two distinct types: administrative and analytical. Administrative workpapers encompass such items as time budgets and other engagement control matters. Analytical workpapers include documentation of data collection and analysis, such as briefs of interviews and excerpts from journals, and procedural documentation such as flowcharts which portray the flow and distribution of information.

Extent of Documentation. The extent of documentation typically is influenced by the level of engagement detail, the reliability of sources, and the applicability and perishability of information. The level of documentation detail is a function of the degree or depth of study; for example, a detailed systems design engagement requires more documentation than a preliminary systems review.

In all cases, care should be exercised to include the source of the information. Omission of the source of information can render a document useless if at a later date it cannot be traced to its origin. Source identification should consist of names of individuals or documents, dates of events, publications, and so forth.

Documentation of the Consultant's Analytical Approach. Documentation of the consultant's analytical approach and process should—

a. Provide a record of the fact-finding process.

b. Document the research undertaken.

c. Indicate the alternatives considered. This documentation should indicate the consultant's judgment used on the information collected and the resulting conclusions and alternative solutions found. The workpapers should also indicate any reasons for rejecting alternative solutions or for not recommending what would appear to be the optimal solution (for example, client constraints).

d. Support the conclusions reached. The alternative finally selected for recommendation to the client should be clearly indicated in the workpapers. Often the specific recommendation, and the reasons for selecting that recommendation over other alternatives, may best be documented in narrative fashion in a final report to the client, with a copy included in the workpapers.

Legal Liability Considerations. Litigation against consultants usually involves allegations of breach of contract, negligence, or misrepresentation. Thus, it is important for the consultant's workpapers to provide documentation that the engagement (a) was performed with due professional care and (b) complied with the terms of the engagement and professional standards. The consultant should also document all significant representations made to the client. For example, assume while providing financing services the consultant only considers two alternative methods of financing and does not indicate why only two were considered. If a dispute later arises over the recommendation, attorneys for the plaintiff are likely to focus very critically on that documentation failure.

Preparing a Draft Report

SSCS No. 1 requires communication of significant engagement findings or events. A written report is recommended in most consulting engagements. It is considered good consulting practice to review draft reports with clients. This should be done after a review of the workpapers. Each page of the draft report should be marked "Draft—For Review Purposes Only."

Conferring with Client

The conference at which the draft report is discussed with client management is the appropriate point to obtain a client representation letter. A client representation letter is not a necessity in all types of consulting engagements. However, a letter should be obtained whenever any information provided by management was used as the basis for assumptions or other parts of the consulting report.

REVIEW, REPORTING, AND FOLLOW-UP OF THE ENGAGEMENT

This section discusses the engagement activities that occur after fieldwork has been completed and a preliminary draft report has been discussed in a client conference. As noted in Exhibit 1-2, the engagement review, reporting, and follow-up phase of a consulting engagement includes the following steps:

a. Engagement review.

b. Report approval and production.

c. Report presentation and distribution.

d. Engagement follow-up.

Engagement Review

Review of Workpapers. Before the draft report is discussed with the client, the engagement workpapers should be reviewed to determine the following:

a. The engagement has been adequately planned; that is, the approach and tasks in the engagement program are appropriate for the nature and scope of the engagement and are adequate to achieve the engagement objectives, as defined by the understanding with the client.

b. The engagement program and workpapers show that the program steps were performed, who performed and reviewed the work, and that the work is complete.

c. The workpapers provide evidence that sufficient relevant data was obtained to fulfill the engagement objectives; that is, the information affords a reasonable basis for analyzing courses of action and supports conclusions or recommendations.

d. Other applicable professional standards were adhered to, for example, attestation standards or SSARS.

Review of Report. The report should be reviewed to determine that it conforms with the following standards:

a. The report communicates the results of the engagement, that is, the significant findings and events.

b. The report communicates any significant reservations concerning the scope or benefits of the engagement.

c. The report communicates any conflicts of interest the practitioner or the firm may have when the practitioner or firm has a significant relationship with another person, entity, product, or service that could be viewed as impairing the practitioner's objectivity.

d. Any other applicable reporting standards are met, for example, specific reporting requirements in attestation or compilation and review standards.

e. The information, data, conclusions, and recommendations in the report are supported by sufficient relevant data obtained in the engagement and documented in the workpapers.

Report Presentation and Distribution

Consulting Services Standards. SSCS No. 1 requires communication of the findings of a consulting services engagement to the client. The final report to the client may be written or oral. When determining whether the report should be written or oral, it is recommended that the consultant consider factors such as:

a. The understanding with the client.

b. The degree to which the engagement results are provided to the client as the engagement progresses.

c. The intended use of engagement results.

d. The sensitivity or significance of material covered.

e. The need for a formal record of the engagement.

The consultant not issuing a written report may wish to consider preparing an outline to the files of engagement results received and documentation provided to the client. Whether written or oral, the final report should meet the requirements specified by consulting services standards. In addition to complying with the consulting services standards, the consultant must adhere to any other reporting standards applicable to the engagement, that is, SSARS for historical financial statements and SSAEs for financial forecasts and projections.

Report Format and Content. Consulting services standards do not specify report format or wording to meet the fairly broad consulting services reporting requirements. Nevertheless, it is recommend that consulting services reports include a separate introductory section, or transmittal letter containing certain caveats or disclaimers implied by the broad consulting services requirements, and incorporating or making reference to any other standard AICPA reports required for the particular engagement.

In addition to the generalized section of the report mentioned above, a consulting services report will contain a highly individualized section that presents the engagement results, findings, events, conclusions, or recommendations. There are two basic types of reports: the closing letter and the comprehensive report.

Closing Letter. When the nature of the engagement does not involve conveying findings, conclusions, and recommendations, a closing letter is sent to signal the client that the engagement has ended. That may be the case when the engagement has involved staff services, implementation services, or other engagements focusing on performance of tasks for the client rather than development of information and recommendations.

A closing letter briefly states the purpose of the engagement, summarizes what was accomplished, and indicates that the engagement has ended.

Comprehensive Report. The comprehensive report traditionally gives complete coverage of the following topics in the logical sequence indicated:

a. Purpose of the engagement.

b. Approach and scope of the engagement, including methods and analysis employed.

c. Findings and observations.

d. Conclusions and recommendations.

The comprehensive report may also include a description of the client and its industry and operations. If additional information is necessary to support findings or recommendations in the report, additional detailed information, for example, statistics, tables, supporting computations, survey results, flow-charts, etc., can be added as separate sections presented after the report.

Liability Considerations and Reporting. Because consulting services standards do not prescribe standardized wording for final reports, the consultant must be particularly careful that the report does not convey any unintended or unwarranted representations that could increase the consultant's liability should disputes or lawsuits related to the consulting service arise. In addition to careful adherence to Statements on Standards for Consulting Services and other applicable AICPA reporting standards and use of the generalized introductory sections or transmittal letters, the following guidelines for preparing the final report are recommended:

a. Facts and opinions should be clearly segregated and distinguished in the final report.

b. Except to the extent that the firm is offering additional services to the client, reports should not contain "selling" language related to the matter under study.

Report Distribution. The consultant should be wary of client requests for an excessive number of copies of a final report for which distribution is restricted under the terms of the engagement. Such a request might indicate client plans for inappropriate distribution. Also, the consultant should discourage requests by clients to distribute copies of the report directly to outsiders unless the request is made in writing and the consultant's consent is obtained.

Summary of Steps to Avoid Liability. The following key points should be kept in mind to avoid unnecessary legal liability in small business consulting engagements. As can be seen, they go beyond just reporting matters.

a. Define the engagement clearly and specifically in an engagement letter.

b. Do not "oversell" your firm's ability. For your first consulting engagement in a new area of expertise, consider whether an experienced consultant should review your work.

c. Maintain comprehensive workpapers. Demonstrate adherence to applicable professional standards and engagement requirements, including planning and supervision.

d. Do not leave unanswered questions or conflicting answers in the workpapers.

e. Prepare final reports that carefully distinguish fact and opinion and be sure findings and recommendations are consistent with and supported by the underlying facts documented in the workpapers.

f. Adhere to AICPA reporting standards for historical or prospective financial information included in the consulting report.

Engagement Follow-up

When a firm has performed a small business consulting engagement for a client and issued a final report, the consulting work is not necessarily finished. The client will typically expect assistance in implementing recommendations. Often, this assistance becomes the subject of a separate engagement, which should be documented in a separate engagement letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

4. Most small business consulting engagements are initiated by a discussion between a representative of the accounting firm and the potential client. It is customary for the discussion to be initiated by any of the following **except**:

    a. The potential client.

    b. The accounting firm.

    c. A third party.

    d. Either the potential client or the accounting firm.

5. Of the following statements, which one is accurate regarding billing of preliminary surveys?

    a. Preliminary surveys that address basic questions in a limited way are usually billed separately.

    b. Diagnostic surveys that perform a brief engagement or the first phase of a potentially long engagement are always billed separately.

    c. Diagnostic surveys are completed by many consultants free of charge.

6. An engagement plan and budget should include all of the following **except**:

    a. All steps needed to successfully complete the engagement.

    b. Development activities.

    c. Client meetings.

    d. Report preparation.

7. Which of following is the last step in the engagement conduct and control phase of a consulting engagement?

    a. Meeting with the client.

    b. Assembling workpapers.

    c. Preparing the draft report.

    d. Conferring with the client.

8. Which of the following statements is accurate regarding each task in the detailed engagement program?

    a. Each task should be described so even the most inexperienced consultant will know exactly what to do.

    b. The degree of detail in each task is determined by the client for whom the engagement program has been undertaken.

    c. The tasks specified in the work program should, among other things, include conferences with the client.

    d. The editing of the final report is the responsibility of the client, not the consultant performing the engagement.

9. Which of the following is **not** one of the primary methods of data collection in consulting engagements?

    a. Discussions with clients.

    b. Computer data base research.

    c. Gathering and reviewing documents.

10. Workpapers can be classified into two distinct types. Which of the following is **not** one of those two distinct types of workpapers?

    a. Preliminary.

    b. Analytical.

    c. Administrative.

11. Obtaining a client representation letter should take place at what step during the consulting engagement?

    a. Data collection and analysis.

    b. Initial meeting with the client.

    c. Assembling workpapers.

    d. Discussion of draft report with client management.

12. Which of the following statements regarding the final report is accurate?

    a. Consulting services standards prescribe standardized wording for the final report.

    b. Facts and opinions do not need to be segregated in the final report.

    c. Distribution of copies of the final report directly to outsiders by the client is discouraged.

    d. All final reports should contain "selling" language related to the matter under study.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

4. Most small business consulting engagements are initiated by a discussion between a representative of the accounting firm and the potential client. It is customary for the discussion to be initiated by any of the following **except**: **(Page 240)**

   a. The potential client. [This answer is incorrect. The discussion may be initiated by the potential client as a result of a recognized need for consulting services.]

   b. The accounting firm. [This answer is incorrect. The discussion may be initiated by the accounting firm based on identification of a consulting opportunity.]

   c. A third party. [This answer is correct. It is not appropriate for a third party to initiate the discussion between parties of the accounting firm and the potential client since a third party will not have first-hand knowledge of the need or opportunity for a consulting engagement.]

   d. Either the potential client or the accounting firm. [This answer is incorrect. The discussion may be initiated by either the potential client or the accounting firm depending on which party recognizes their need or opportunity, as applicable.]

5. Of the following statements, which one is accurate regarding billing of preliminary surveys? **(Page 240)**

   a. Preliminary surveys that address basic questions in a limited way are usually billed separately. [This answer is incorrect. Preliminary surveys that address basic questions in a limited way are severely limited in scope, require limited time and are seldom billed or reported on separately.]

   b. Diagnostic surveys that perform a brief engagement or the first phase of a potentially long engagement are always billed separately. [This answer is incorrect. Diagnostic surveys that perform a brief engagement or the first phase of a potentially long engagement are sometimes, but not always billed separately.]

   c. Diagnostic surveys are completed by many consultants free of charge. [This answer is correct. Diagnostic surveys are completed by many consultants free of charge in the hope that the survey results will highlight one or more consulting opportunities that can subsequently be sold to the client on a fee basis.]

6. An engagement plan and budget should include all of the following **except**: **(Page 241)**

   a. All steps needed to successfully complete the engagement. [This answer is correct. An engagement plan and budget does not document all the individual steps necessary to successfully complete the engagement. Therefore, a detailed and comprehensive work plan should also be prepared.]

   b. Development activities. [This answer is incorrect. An engagement plan and budget should be completed before a proposal is submitted to a client to consider the major tasks needed to quote time and fees. One such task to be considered is development activities.]

   c. Client meetings. [This answer is incorrect. One of the major tasks that need to be considered when completing an engagement plan and budget prior to submittal of a proposal to a client is that of client meetings.]

   d. Report preparation. [This answer is incorrect. Report preparation is one of several major tasks that should be considered when an engagement plan and budget is being completed.]

7. Which of the following is the last step in the engagement conduct and control phase of a consulting engagement? **(Page 242)**

   a. Meeting with the client. [This answer is incorrect. Meeting with the client is the fifth step in the engagement conduct and control phase of a consulting engagement and follows the step involving controlling engagement time.]

   b. Assembling workpapers. [This answer is incorrect. Assembling workpapers is the sixth step in the engagement conduct and control phase of a consulting engagement and follows the step covering meeting with the client.]

   c. Preparing the draft report. [This answer is incorrect. Preparing the draft report follows the step dealing with assembling workpapers. However this step is not the last step in the engagement conduct and control phase of a consulting engagement.]

   d. Conferring with the client. [This answer is correct. After all other steps in the engagement conduct and control phase of a consulting engagement have been completed, and a draft report has been prepared, conferring with the client is the last step in the engagement conduct and control phase of the engagement.]

8. Which of the following statements is accurate regarding each task in the detailed engagement program? **(Page 243)**

   a. Each task should be described so even the most inexperienced consultant will know exactly what to do. [This answer is incorrect. Each task should be described so an *experienced* consultant will know precisely what to do.]

   b. The degree of detail in each task is determined by the client for whom the engagement program has been undertaken. [This answer is incorrect. The degree of detail in each task depends on the experience of the consultants assigned and the size and complexity of the engagement.]

   c. The tasks specified in the work program should, among other things, include conferences with the client. [This answer is correct. Tasks specified in the work program should include conferences with the client, supervision, and preparation of progress reports. The consultant should plan for the involvement of client personnel.]

   d. The editing of the final report is the responsibility of the client, not the consultant performing the engagement. [This answer is incorrect. The *consultant* is responsible for the editing of the final report.]

9. Which of the following is **not** one of the primary methods of data collection in consulting engagements? **(Page 243)**

   a. Discussions with clients. [This answer is incorrect. One of the primary methods of data collection in consulting engagements is the process of interviewing clients to gather as much information as possible from them directly.]

   b. Computer data base research. [This answer is correct. Computer data base research is not one of the primary methods of data collection in consulting engagements. Researching existing publications would be a more effective way to collect data for the consulting engagement.]

   c. Gathering and reviewing documents. [This answer is incorrect. Another of the primary methods of data collection in consulting engagements is the gathering and analysis of pertinent documents.]

10. Workpapers can be classified into two distinct types. Which of the following is **not** one of those two distinct types of workpapers? **(Page 244)**

    a. Preliminary. [This answer is correct. Preliminary workpapers are not one of the two distinct types of workpapers. All workpaper-related issues would fall under either administrative or analytical workpapers.]

    b. Analytical. [This answer is incorrect. Analytical workpapers are one of the two distinct classifications of workpapers and include documentation of data collection and analysis and procedural documentation such as flowcharts per the Statements.]

    c. Administrative. [This answer is incorrect. One of the two distinct types of workpapers are administrative workpapers. Administrative workpapers include such things as time budgets and other engagement control matters per the Statements.]

11. Obtaining a client representation letter should take place at what step during the consulting engagement? **(Page 245)**

    a. Data collection and analysis. [This answer is incorrect. Data collection and analysis occurs very early in the engagement, far too early to obtain a client representation letter.]

    b. Initial meeting with the client. [This answer is incorrect. The initial meeting with the client occurs early in the engagement, just after data collection and analysis, and a client representation letter is not appropriate at this step in the engagement process.]

    c. Assembling workpapers. [This answer is incorrect. Assembling workpapers occurs subsequent to the initial meeting with the client, and obtaining a client representation letter does not occur at this stage in the engagement.]

    d. Discussion of draft report with client management. [This answer is correct. After workpapers have been assembled, the draft report is prepared. The conference with client management to discuss the draft report is the appropriate time to obtain a client representation letter. A client representation letter should be obtained any time information provided by management has been used as the basis for assumptions or other parts of the consulting report.]

12. Which of the following statements regarding the final report is accurate? **(Page 247)**

    a. Consulting services standards prescribe standardized wording for the final report. [This answer is incorrect. Consulting services standards do *not* prescribe standardized wording for final reports. Therefore, the consultant must be particularly careful that the report does not convey any unintended or unwarranted representations.]

    b. Facts and opinions do not need to be segregated in the final report. [This answer is incorrect. Facts and opinions should be clearly segregated and distinguished in the final report. Consultants must be careful to prevent any disputes or lawsuits.]

    c. Distribution of copies of the final report directly to outsiders by the client is discouraged. [This answer is correct. The consultant should discourage requests by clients to distribute copies of the report directly to outsiders unless the request is made in writing and the consultant's consent is obtained.]

    d. All final reports should contain "selling" language related to the matter under study. [This answer is incorrect. Final reports should not contain "selling" language related to the matter under study, except to the extent that the firm is offering additional services to the client.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (CONTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Under _____ of the AICPA *Code of Professional Conduct,* members are required to comply with the consulting standards.

   a. Rule 201.

   b. Rule 202.

   c. Rule 101.

   d. Rule 102.

2. Of the following general standards, which one was added by SSCS No. 1 for consulting services?

   a. Client interest.

   b. Due professional care.

   c. Planning and supervision.

   d. Professional competence.

3. Which of the following best describes when the AICPA's quality control standards apply?

   a. All consulting services.

   b. Only to the portion of a consulting engagement to which SASs apply.

   c. Only to the portion of a consulting engagement to which SSARSs apply.

   d. Only to the portion of a consulting engagement to which SASs, SSARSs, or SSAEs apply.

4. Bill, having recognized a need for consulting services, is a potential client of Brown & Anderson accounting firm. Bill desires a precise engagement definition that has resulted in a preliminary survey being performed by Brown & Anderson. What should the next step be in planning for the consulting engagement?

   a. Completing engagement acceptance procedures.

   b. Preparing an engagement plan and budget.

   c. Gaining an understanding of the company.

   d. Preparing the proposal.

5. After completion of the preliminary survey, it is unnecessary for Brown & Anderson to obtain additional background data:

   a. When deciding whether to accept Bill as a client.

   b. When planning a detailed work program after accepting the engagement.

   c. As part of the data gathering process.

   d. As part of the engagement follow-up process.

6. Inclusion of which of the following in the proposal best demonstrates the firm's qualifications to perform the engagement?

   a. The annual revenue of the firm.

   b. The number of employees in the firm.

   c. Recommendations from other satisfied clients.

   d. Descriptions of similar engagements performed.

7. Jackson Consulting provided their prospective client, BD Corporation, with a written proposal for a consulting engagement. BD Corporation agreed to have Jackson Consulting perform the engagement. Subsequently, Jackson Consulting has developed a detailed engagement program, collected data, and analyzed that data. What is the next step in the conduct and control phase of the engagement that Jackson Consulting will undertake?

   a. Meeting with BD Corporation.

   b. Controlling engagement time.

   c. Assembling workpapers.

   d. Preparing the draft report.

8. Which of the following matters must be covered in a detailed engagement program but is **not** one of the tasks to be performed to achieve the engagement objectives?

   a. Interviewing personnel.

   b. Studying techniques to be used.

   c. Contacting outside sources for information.

   d. Preparing reports.

9. During the data collection process of an engagement, the consultant usually conducts interviews. According to the text, which of the following is probably the most important step in the interview preparation process?

   a. Arrange comfortable facilities.

   b. Analyze the other person.

   c. Gain the interviewee's confidence before the interview.

   d. Plan the type, use, and sequence of questions.

10. Which of the following does **not** require that the CPA consultant prepare workpapers?

    a. SSCS No. 1.

    b. SSAE No. 11.

    c. SSAE No. 12.

    d. SSAE No. 13.

11. The extent of documentation generally is influenced by all of the following circumstances **except**:

    a. The level of engagement detail.

    b. The discretion of the consultant.

    c. The reliability of sources.

    d. The applicability of information.

12. Subsequent to completion of fieldwork and discussion of a preliminary draft report in a client conference, the next engagement activity should occur during which of the following?

    a. Report approval and production.

    b. Report presentation and distribution.

    c. Engagement review.

    d. Engagement follow-up.

Lesson 2: Consulting—Financing Services

INTRODUCTION

For the purposes of this lesson, financing is broadly defined as any flow of funds into a business from sources other than the business's own operations to provide financial resources for the continuation or expansion of operations. This includes equity and short-term or long-term debt. A consultant may assist a construction client with financing alternatives in some or all of the following activities, which are discussed in this lesson.

a. Deciding whether financing is needed.

b. Determining the underlying reason why financing is needed.

c. Deciding how much financing is needed.

d. Deciding what type of financing should be obtained and from what particular sources.

e. Preparing a financing proposal for submission to a potential provider of financing.

f. Negotiating the financing with a potential provider.

This lesson is organized by the following topics:

a. Practice administration.

b. Determining the client's financing needs.

c. Costs associated with financing.

d. Types of financing.

e. Preparing a financing proposal.

f. Negotiating the financing.

g. Engagement activities and administration.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify financing services and determine the client's financial needs and the types of financing available to fulfill those needs.
- Prepare a financing proposal.
- Identify critical points in negotiating financing.

Practice Administration

The advice cited above on consulting practice administration and general consulting standards is generally applicable to financing services engagements. In addition, the following considerations apply to generating, staffing, and billing those engagements.

Generating Engagements. A firm can build on its expertise in the construction industry by providing specialized financing services consulting to its construction contractor clients. This specialization may offer added advantages because of the many financing sources that exist. It may be easier for a small firm to become known as an expert in a few specialized areas than attempt to be an expert in all areas.

Recognition of a contractor's changing business model can signify needs for different types of financing. If the contractor plans to increase revenues, it might need to increase its line of credit to fund the increase in monthly expenses on the project that will occur before customer payment is received. Also, long-term financing to fund the increased retention may be needed. A contractor that decides to increase its inventory or buy materials early to protect itself from price increases might need to finance the additional holding period. A contractor that plans to expand its property, plant, and/or equipment might find it better to repackage its existing equipment with new equipment as collateral for a loan rather than just financing the current acquisitions.

Accounting firm personnel performing accounting, tax, or audit engagements should be alert for indications of possible financing needs, and a consulting engagement might result to help a contractor assess its needs. If the financing services are for an existing attest client or will involve attest services, such as reporting on prospective or historical financial information, the firm needs to ensure that all of the applicable independence and documentation requirements of Ethics Interpretation 101-3, "Performance of Nonattest Services," are met.

A firm wishing to provide financing services consulting should maintain relationships with local lenders. For example, the firm's own banker and clients' banks may be sources of referrals. Surety companies or surety agents may also provide referrals.

Advertising. The ethics interpretation at ET 502.03 prohibits advertising activities that "create false or unjustified expectations of favorable results" or that "imply the ability to influence any court, tribunal, regulatory agency, or similar body or official." With respect to financing services consulting, this would include expectations of obtaining financing or the ability to influence officials of governmental agencies that provide or guarantee loans.

Staffing and Training. Staffing requirements for consulting engagements depend on the competence level, skills, and experience required for the engagement. Even if a firm specializes in only a few types of financing, it probably needs to be at least generally knowledgeable about the array of available products and services. Because of the numerous types of financing, the firm might allocate responsibility for maintaining current knowledge of specific products and services among several consultants. For example, one person might keep current on regulations related to government financing programs, while another concentrates on inventory, accounts receivable, and equipment-based financing methods. These persons would handle engagements expected to involve their area of expertise, or they could advise other firm consultants when necessary.

In addition to keeping up to date with current developments in their area, the firm "experts" should maintain contact with appropriate outsiders, for example, officials at commercial finance companies, banks, or a Small Business Administration (SBA) office. Also, the firm expert may help train staff consultants.

A financing services engagement often involves helping the client negotiate with a potential provider of financing. The firm should keep this in mind when staffing engagements. Although a staff consultant may participate in some aspects of the engagement, negotiation assistance is most appropriately performed by an experienced consultant.

Fee Considerations. Generally, a firm cannot guarantee a client that its service will lead to the client's obtaining financing because the decision about granting financing rests with the potential provider. Knowing that, the firm might be tempted to offer or accept fee structures contingent on whether the financing is obtained or based on a percentage of the amount of financing obtained. Before offering or accepting a contingent fee arrangement, or a commission for referring the client to a particular financing source, the practitioner should consider the guidance in this lesson relating to prohibitions and restrictions on such fee arrangements.

The consultant usually is prohibited from charging contingent fees. However, in setting fees for financing services consulting, the consultant can consider the skills required and the benefit to be derived by the client. Often, premium rates can be charged for financing services consulting. The consultant should consider obtaining a retainer before starting the financing services engagement, especially if the prospective client is willing to pay premium rates due to an extraordinary liquidity need.

Determining the Client's Financing Needs

The first phase of the engagement generally consists of the consultant's consideration or recognition of the client's financing needs, including consideration of the following matters:

a. What are the funds needed for?

b. How much funding is needed?

c. How will the funds be repaid?

d. What types of financing are available, and what are their advantages and disadvantages (including relative costs and financial and other effects)?

These considerations are made by discussion with the client and by analysis of financial information in light of the consultant's knowledge of the client, its industry, and available financing vehicles. The purpose of the considerations is to recommend a financing plan for the client to pursue, either alone or with the consultant's assistance in a second phase of the engagement. The considerations are discussed below. The importance of carefully analyzing financing needs cannot be underestimated. The Small Business Administration indicates that while poor management is the most common reason for business failure, inadequate or ill-timed financing is a close second.

What Are the Funds Needed for? There are many reasons why companies need financing, including:

a. Start-up capital.

b. Additional working capital.

c. Acquisition of machinery and equipment.

d. Purchase of real estate.

e. Acquisition of another business.

f. Repurchase of equity shares outstanding.

g. Refinance existing debt obligations.

The consultant needs to consider the client's stated reason carefully because it may suggest the following:

a. *The appropriate source to pursue and whether the client is likely to have difficulty obtaining funds.* For example, some lenders might be more reluctant to lend funds for working capital needs than to lend funds for purchasing fixed assets that can be used as collateral on the loan. If the need for the funds is clearly understood, any potential financing difficulties associated with it can be anticipated and addressed in a financing proposal in the most advantageous way.

b. *The financing term to seek.* As a general rule, the life of an acquired asset should at least equal the term of the financing needed to acquire it. Thus, short-term financing may be used for working capital, medium-term financing may be used to acquire machinery and equipment, and long-term financing should be obtained for start-up capital or for acquiring real estate or another business.

c. *The most advantageous way to present the request to potential providers.* For example, a request for working capital to finance increased revenue may be accompanied by information about future revenue estimates, contract backlog, and receivables aging. This information helps support a client's claim that the funds are needed to further growth rather than because of poor cash management.

The consultant should critically assess the client's conclusion that outside financing is needed. It may be that the client's cash needs can be met by improving internal cash management, and the client may avoid unnecessary borrowing costs by correcting the cash management problem.

The consultant's initial considerations of the reasons for needed cash might indicate that fundamental decisions and choices about the direction of the business need to be made in a basic business plan. Also, the cash shortage might be a sign of severe financial strain, that is, a sign that the business is in trouble. In either case, the client might actually need services other than the more narrow financing service it has requested.

How Much Funding Is Needed? After the financing reasons are determined, the consultant should carefully analyze the amount that is needed. The intended purpose of the funds may suggest the appropriate amount to obtain or a way to estimate the amount needed. For example, if the client wants to acquire construction equipment, determining the amount needed may be as simple as referring to the invoice cost of that equipment. If, however, the client's need is for working capital to carry it through a seasonal slump or a peak period, a more complex process of estimating monthly or quarterly cash flow may be necessary to determine an appropriate amount of financing to seek.

In general, the following steps are necessary to develop prospective financial information to estimate financing needs:

a. Identify key factors relating to the operations causing the need for financing or affected by the financing. For example, the cost of equipment to be acquired is a key factor if the financing is needed for that purpose, and the components of working capital (receivables collections, payables disbursements, etc.) are key factors if financing is needed for working capital.

b. Develop assumptions for each key factor identified.

c. Translate assumptions into prospective financial data, for example, prepare a prospective cash flow statement using the assumed amounts of receivables collections, etc.

d. Review the prospective information for reasonableness.

How Will the Funds Be Repaid? Repayment is an important consideration in deciding on the best form of financing. The major considerations regarding repayment are whether the asset to be acquired will provide enough cash to repay the loan needed to acquire it and the length of the repayment period.

As previously mentioned, a loan obtained to acquire an asset should not have a longer term than the asset acquired. If the asset to be acquired will not generate enough cash to repay the funds needed to acquire it, the client should reevaluate the benefits of the asset. If the client believes that the asset is essential, a source other than a loan should be considered, such as equity funding.

The source of repayment of a loan for working capital related to business growth should be the additional cash flow from the expanded volume. Prospective financial information, for example, a prospective cash flow statement, can be prepared to assess the ability to generate sufficient funds to repay the loan.

If the loan is to be used for the acquisition of another business, the profits and cash flow from that business should be the source of repayment. Another source of repayment of a business acquisition loan might be disposition of unneeded assets of the acquired business. For example, if a contractor acquired another contractor, it is likely that there would be some duplication of equipment. To the extent that both sets of equipment are not necessary, one set could be sold to help finance the acquisition. In either case, consideration must be given to the feasibility of the expected repayment plan.

What Costs Are Associated with Financing?

When comparing financing sources, the consultant should be aware that it may be difficult to compare the cost of funds borrowed. For instance, commercial loan rates are often negotiated in terms of premiums to and discounts from the prime rate, and the "prime" rate may be different from bank to bank. Also, depending on the type of loan and the competitive environment, commitment or other fees may be charged. Some banks also require the company to maintain a compensating balance in either an interest bearing or noninterest bearing account. Therefore, it is important for the consultant to ensure that the loan terms being negotiated are clear.

What Types of Financing Are Available?

A client's first impulse might be to seek a loan from a bank with which the company maintains a checking account, but that bank loan may not be the best source for the client. Thus, a consultant can provide a valuable service by informing the client of various potential sources that might not be obvious. The following information categorizes the available forms of financing by repayment period, that is, short-term, medium-term, and long-term, rather than by source, because some types of financing are available from more than one source.

Private Sources of Financing. Before undergoing a formal financing process, the client should consider sources of private financing. Although private financing may not perfectly fit the company's needs, the savings in time and energy and the avoidance of sharing confidential operating information may outweigh the disadvantages. In the early stages of a construction company, private sources of financing may be the only option for the company since it may not have established enough history to support more conventional financing methods. Some of the private sources that may be considered are discussed below:

a. *Personal Sources.* Loans or equity contributions can be made from the owner's personal resources, for example, liquidation of savings accounts, stocks, or bonds, or from loans obtained through personal sources, such as mortgages on residences, personal lines of credit, credit card advances, or loans against the cash value of life insurance policies. Funds can often be obtained from personal sources more quickly than from other sources, and sometimes at a lower cost, as in a loan against an insurance policy. A disadvantage is that the client may give up the personal security of a funds source for a future personal emergency.

b. *Partners, Stockholders, or Employees.* Existing partners or stockholders may be able to make additional equity contributions or loans.

c. *Friends or Relatives.* Sometimes, funds may be obtained from the owner's friends or relatives. Such loans are often made at reduced interest rates in circumstances when other lenders would not make a loan without extensive documentation and burdensome requirements. However, the informal nature of the transaction may lead to later misunderstandings or friction, and related-party loans at below-market interest rates may require that imputed interest income be recognized for income tax purposes. It is believed that if a friend or relative invests in the business, a formal written agreement should be prepared. This will help keep the relationship professional and avoid future misunderstandings about the terms of the arrangement.

d. *Vendors.* Vendors may find that it is in their best interests to ensure that the company continues to buy its product. Accordingly, such vendors might be willing to provide financing in the form of credit or payment terms favorable to the company. When a vendor has construction lien rights, it probably will not be willing to work with a contractor if, by so doing, the vendor would lose its lien rights against a specific construction project.

e. *Customers—Project Owners/General Contractors.* As a result of business expansion, the contractor may need to fund payroll and/or equipment operating costs. Funding may be provided by obtaining contract terms for weekly or semimonthly payments. Contracts may also be negotiated that allow for a reduced retention during performance of the work, and full retention payment for individual work items 60 days after that particular item is complete.

Short-term Financing. The forms of financing discussed below are available for a short term, that is, either on demand or for periods less than one year. Short-term loans may be cheaper and easier to obtain than long-term loans because the lender is at risk for a shorter period of time, the conditions of the loan may not call for payment of principal during the loan term, and they may be easier for the lender to process if they are unsecured, as some short-term loans are.

Credit scoring is common for many banks and other financing entities for smaller loans (originally designed for loans up to $250,000, but primarily used for loans up to $100,000). Credit scoring is usually based primarily on the business owner's personal credit record, rather than the financial statement analysis normally performed for larger

commercial loans. The advantage of credit scoring is the speed of the credit approval process (usually less than a day). However, the disadvantages are the likely personal guarantee requirements for the business owners and the lack of personal contact between the owner and the lender.

Lines of Credit. A credit line, which generally is available through banks, is an agreement that the bank will lend the company funds, as needed, up to a specified amount. The company pays interest only on the amount actually borrowed, not on the entire line. However, some banks charge commitment fees based on the total amount of the line and may impose additional charges for undrawn funds. Generally, commitment fees range from 1/4% to 1/2% of the total amount of the line of credit.

Credit lines are widespread in the construction industry and are not necessarily obtained for a company's cash needs. Sureties often require a line of credit as an additional comfort zone for the surety, even if a company has adequate liquidity for operational purposes. There are three types of credit lines: seasonal, revolving, and non-revolving. A revolving credit line is the most common type used in the construction industry.

Seasonal lines of credit are used by seasonal construction businesses to obtain working capital during certain months of the year. Generally, seasonal lines of credit are granted for periods of 3 to 24 months and continually "rolled over." To be successful in obtaining seasonal lines of credit, contractors must usually pledge their accounts receivable, inventory, and any other short-term assets as collateral.

Line-of-credit commitments must be reapproved each time they expire. In addition, many banks impose a periodic clean-up requirement. That is, the borrower must repay the line and not draw down any other loans from the bank for a period of time, generally 30 to 60 days.

Seasonal lines of credit may be committed or noncommitted. If a seasonal line of credit is noncommitted, the availability of funds is not guaranteed. Unlike noncommitted lines, seasonal committed lines of credit guarantee that credit will be available even during the tightest economic times, but the fees are typically higher (sometimes as high as 1/2 % to 1%).

The revolving line (or "revolver") is similar to a home equity loan. Repayments of principal and interest are made monthly, and amounts repaid are available to be borrowed again. Interest is charged on the funds actually borrowed, and there's usually no additional cost. A revolving line of credit is usually secured by accounts receivable, inventory, and any other short-term assets. Like seasonal lines of credit, revolving lines may be committed or uncommitted. Although revolving lines of credit usually require an annual review and renewal, there normally is no "cleanup" required.

Some contractors use revolving credit to accommodate volatile working capital needs or when they want to finance growth but are unable to precisely forecast financing needs. In some cases, a revolving line of credit is coupled with a term loan. The borrower uses the revolving credit for a period and then converts the obligation to a term note paid out over three to five years.

Another type of line of credit is a non-revolving line. A non-revolving line of credit is typically used for real estate construction, but may also be used for periodic asset purchases. This type of line allows periodic draws but, once repaid, cannot be drawn upon again without new approval.

Demand Note. The term of a demand note is undefined but is callable by the lender at any time. A demand note might not be secured. Interest rates generally float, that is, they are adjusted to correspond to changes in the prime rate.

Receivable Financing. There are two primary ways to obtain financing using the company's receivables: advances against receivables and factoring. Receivable financing provides only an acceleration of collections. That is, the borrower receives today what it would have collected tomorrow; it obtains tomorrow what it would have collected the next day. Contractors considering the use of receivable financing may want to maintain a credit profile for each of their customers to aid in the loan process.

Advances against receivables are made primarily by commercial finance companies and banks. The lender then advances the borrower a specified percentage, such as 60%–80%, of the eligible accounts pledged. However,

receivable financing is more difficult in the construction industry since the financing company does not necessarily obtain any lien rights (unlike the contractor itself).

Factoring. Factoring refers to selling accounts receivable at a discount to a bank or finance company providing the financing. Ordinarily, the receivables are sold *without recourse*, that is, the bank or finance company (called the *factor*) bears the risk of uncollectible accounts. Occasionally, receivables are factored with recourse, and the borrower remains at risk for any uncollectible accounts. If the receivables are sold with recourse, the discount rate is usually less, which means that the borrower receives a higher percentage of the receivable balance being sold. However, since discount rates used in factoring are normally substantial (for example, they can be 15%–20%), factoring is rarely used by construction contractors who might only bid their jobs at profit rates of up to 10%.

Inventory Financing. Banks and finance companies also provide financing based on companies' inventories. This source of financing is not as widespread in the construction industry because most contractors do not carry substantial inventories. (Construction in progress is not considered inventory for financing purposes.) It may be appropriate for certain service contractors, such as plumbing or electrical contractors, whose inventories may be more substantial. Lenders usually provide less money for a given value of inventory than for an equal value of receivables. The loan may be collateralized by specific items of inventory or by the inventory in total.

Commercial Paper. Financing through commercial paper generally is feasible only for large companies. It is not used very often in the construction industry. However, smaller contractors sometimes can use a variation of that financing method in which commercial paper is issued at a discount, and the borrower (issuer of the commercial paper) repays the face amount. The effective interest rate is usually significantly below the prime rate and the rate at which the borrower could borrow on a line of credit. The borrower issues the paper through a commercial paper dealer after a commercial paper rating is obtained from the major rating agencies. Because a rating will not normally be issued unless the borrower has obtained a rating on its long-term debt or preferred stock, most small companies cannot issue commercial paper. However, some banks will substitute their credit standing for the borrower's by issuing a formal guarantee or an irrevocable letter of credit to back up the paper. There is a fee for this service, and a medium-size company would expect to pay the bank 1%–1.5% of the amount to be guaranteed.

Asset-based Lending. Asset-based lenders are similar to other short-term lenders in that they often finance accounts receivable, inventory, and fixed assets. (Construction in progress is not considered inventory for financing purposes.) Asset-based lenders provide contractors an opportunity to generate both cash and working capital from their heavy equipment and scrap metals. Asset-based lenders will make loans to companies that are highly leveraged or lack strong cash flow. In some cases, asset-based lenders accept collateral that is not attractive to banks. There are typically no compensating balance requirements or extensive loan covenants, for example, maintaining specified working capital ratios. However, asset-based lenders charge higher interest rates (often two to three percentage points higher) and maintain tight controls over collateral.

Medium-term Financing. Medium-term financing (term of one to five years) may be secured or unsecured, depending on the borrower's creditworthiness. Such financing often entails a formal loan agreement with restrictive covenants that limit the amount of the borrower's capital expenditures or dividends or requires certain working capital levels and financial ratios to be maintained. Medium-term financing includes leasing arrangements, term loans, and government loan programs.

Machinery and Equipment Financing. Suppliers of machinery and equipment often provide financing for buyers. Some suppliers accept term notes for the purchase price while others provide installment payment plans (either on their own or through a lending institution). If the company owns equipment that is in good condition and free of liens, it can sometimes pledge the equipment as collateral for a loan. The proceeds of such a loan are often based on liquidation value and may bear little relation to the equipment's replacement cost or book value.

Leasing. Some companies choose to lease new equipment rather than buy and finance it. Various types of leases exist with different responsibilities for both lessor and lessee. A leasing arrangement conserves cash because of a small down payment, generally is less restrictive than a debt agreement, and provides some protection against obsolescence because the company may return the equipment at the end of the lease term. The major disadvantage is that the company does not own the asset at the end of the lease term, although the equipment can often be purchased for a nominal amount at that time, particularly under a long-term financing lease. Also, although a transaction may be structured as a lease, it may be considered a purchase for tax and financial reporting purposes.

Rent with an Option to Buy. Some manufacturers rent construction companies equipment with an option to buy. The advantages to that type of arrangement are that (a) it conserves cash initially because only a deposit and the first month's rent is usually collected up front, (b) there is no commitment to purchase the equipment (so if a contractor has only one contract where the equipment is needed, it can be rented for that contract period only), and (c) any rents paid are usually treated as reductions of the purchase price of the equipment, if it is ultimately purchased. The primary disadvantage is that the purchase price is generally more a retail price than a negotiated purchase price.

Term Loans. New and used machinery and equipment loans are generally structured as term loans secured by specific machinery or equipment. Borrowers generally repay the loans in monthly or quarterly installments over one to ten years, depending on the estimated life of the collateral. Interest rates may be either fixed or variable, depending on the bank. Most banks will normally advance 70% to 95% of the fair market value of new machinery or equipment and 50% to 80% of the quick sale value of used machinery or equipment, which is established by banks based on values listed in trade or industry guides available from equipment dealers.

Mezzanine Financing. Mezzanine financing is generally unsecured and subordinated to senior debt. Mezzanine lenders usually lend to highly leveraged companies for recapitalizations or leveraged buyouts. In return for the subordinated debt position, the lender will receive a higher interest rate and an equity participation in the company, usually through warrants, preferred stock, or a debt conversion feature.

Small Business Administration Loans. In addition to disaster assistance, the Small Business Administration (SBA) guarantees small business loans made by banks or other lenders. Most SBA loans are medium-term loans, but they may be short-term or long-term depending on the purpose. For example, maturities may vary from 5 to 10 years for working capital loans, 10 to 25 years for machinery and equipment loans, and up to 25 years for real estate financing. Most SBA term loans are used by construction companies to finance facilities. In 2008, the AICPA and the SBA signed a strategic alliance agreement which provides CPAs greater access to the SBA's programs and nationwide network. CPAs may draw on SBA resources to help their clients finance start-ups, expansions, and recover from natural disasters. Additional information and resources available to CPAs can be found at **http://www.aicpa.org/INTERESTAREAS/PRIVATECOMPANIESPRACTICESECTION/RESOURCES/USSBA/Pages/default.aspx**.

Some state and local agencies can provide financing to a small business, or woman, or minority-owned businesses.

Long-term Financing. Long-term financing may be the most difficult for a construction contractor to obtain. With the exception of mortgage loans, lenders generally do not like to give long-term loans to small businesses. Generally, lenders try to secure as much collateral as possible and ask for liens not only on the assets they finance but also on construction in progress, inventories, receivables, or the owner's personal assets. Sometimes an alternative to long-term debt financing is equity financing. In the construction industry the majority of outside capital is from private equity firms.

Equity Financing. Financing through equity is generally less costly than debt because there is no interest cost and equity usually does not have to be repaid. Another benefit to equity financing is that a larger equity base may make it easier to obtain credit and make a contractor's financial position more favorable toward sureties. A disadvantage is that issuing equity to new shareholders dilutes the holdings of the existing owners. Also, the new owners may insist on participating in management, which could cause conflicts with existing management. Some potential sources of equity financing include private investors, other corporations (looking for inexpensive access to new technology or markets), and company managers (who want to participate in company growth). Some banks may also have investment divisions with funds available on an equity basis. Over the last decade, equity investment by foreign construction and material supply companies has been more prevalent.

ESOPs. The construction industry has found that many employees want to participate in an Employee Stock Ownership Plan (ESOP). The issuance of stock options and conversion of qualified retirement plans to ESOPs have begun to transform the ownership of construction companies from one to three owners to multiple owners, allowing more capital to be invested in the business enterprise. Additional information about ESOPs is available from the ESOP Association at **www.esopassociation.org** or the National Center for Employee Ownership at **www.nceo.org**.

Venture Capital. Venture capitalists invest in companies they believe will significantly increase in value. They buy stock in the company with the expectation that in three to five years the stock will be worth considerably more than what they paid for it. After that time, they expect either to sell the stock back to the company, arrange a public offering of the company's stock and sell it on the open market, or arrange a merger with a publicly held company. Venture capital is not a common source of financing in the construction industry because construction is a mature industry with less perceived high-growth potential. In addition, contractor sureties may want personal guarantees of a company's owners, and venture capitalists (when they become owners) may not be inclined to give those guarantees. Yet investment by venture capitalists and private equity groups is considered primarily in two construction industry sectors: contractors with a service or recurring customer base such as electrical, HVAC, and plumbing contractors; and construction companies involved in the solar energy market.

For a small fee, the National Venture Capital Association at (703) 524-2549 or **www.nvca.org** can provide a directory of venture capital firms. Some venture capital firms have home pages on the Internet that can be used to obtain information about the firm and content of financing proposals. A list of venture capital clubs is also available on the Internet at **www.businessfinance.com**.

Angel Investors. Angel investors are normally high net-worth individuals who finance small companies for an equity interest. Angel investors may offer more flexible terms and conditions and may be willing to invest at a smaller amount and at an earlier stage in the business' life than venture capital firms. Before investing, they generally undertake formal due diligence procedures and want to know when and how they may cash out their investment. Locating angel investors can be difficult because angel investing traditionally occurs through an informal network.

Joint Venture Partnerships. One method of financing with unique aspects to the construction industry is the use of joint venture partnerships under which two entities get together for a specific purpose or construction project. A primary benefit of the joint venture partnership is the ability of construction contractors to share the risks associated with a given project. The joint venture partnership can take several forms to suit needs unique to the industry.

One form of joint venture partnerships is a partnership created to share the bonding capacity and capital of two construction companies. In the construction industry, contractors may have to meet stringent bonding and capital minimums even to bid on a particular project. A single contractor may be precluded from bidding and winning a project unless it is able to form a joint venture with another company and use the combined strength of the two companies to meet the minimum requirements.

A joint venture partnership could also be structured simply to allow one contractor to use the bonding capacity and capital of another company to obtain a contract. The "loaning" contractor is paid a fee and once the contract is won, the "loaning" contractor is not part of actually completing the project.

Still another form of joint venture partnership is one created between a construction company and an individual owner of a construction company. That partnership essentially combines the strength of both the company and the individual owner to determine bonding capacity. It is more advantageous than the owner providing a personal guarantee to the company, because a personal guarantee is viewed by the sureties only as a contingency source of funds. The joint venture combines the equity of both parties, resulting in a higher bonding capacity.

Small Business Investment Company (SBIC). SBICs are privately managed venture capital firms licensed and regulated by the SBA. SBIC funds come from both private capital and below-market loans from the federal government. The purpose of SBICs is to provide capital to "small businesses" as defined by the SBA. To qualify as a "small business," generally a company must have tangible net worth of $18 million or less and average net income after federal income taxes (excluding carryover losses) of $6 million or less for the last two fiscal years. Information about SBICs in a local area can be obtained by contacting the local SBA office or by contacting the following organizations:

a. Investment Division
   U.S. Small Business Administration
   www.sba.gov/inv
   (800) 827-5722

b. National Association of Small Business Investment Companies
www.nasbic.org
(202) 628-5055

c. National Association of Investment Companies
www.naicvc.com
(202) 204-3001

Public Offerings. There are significant advantages to going public, such as increased marketability of the owners' stock and access to more capital. There are also significant disadvantages, such as diluted ownership and substantial external reporting requirements. Public offerings in the construction industry seem to be more limited than with the population of industries as a whole. However, it has proven to be a useful method of providing the necessary cash to finance buy-outs from retiring contractor-owners.

The Securities and Exchange Commission (SEC) has developed programs to make public offerings of securities easier for small businesses by reducing the securities registration and periodic reporting requirements. These programs include—

a. *Section 3(a)(11) of the Securities Act.* Known as the *intrastate offering exemption*, it exempts from registration any security that is part of an issue offered and sold only to residents of the state in which the company resides and does business. The company has the obligation to determine the residence of each purchaser and if any securities are offered, sold or resold by an original purchaser to an out of state purchaser, the exemption may be lost.

b. *Regulation D.* Regulation D provides exemptions from registration in Rules 504, 505, and 506.

(1) Rule 504 provides an exemption when the offering proceeds during a 12-month period do not exceed $1 million. Rule 504 does not mandate specific disclosures of financial and nonfinancial information, as Rules 505 and 506 do. However, the company should provide sufficient information to meet the full disclosure obligations existing under the provisions of the securities laws. Many companies provide a copy of the Small Corporate Offerings Registration (SCOR) Form (Form U-7) as an offering circular.

(2) Rule 505 provides an exemption when the offering proceeds during a 12-month period do not exceed $5 million. Rule 505 contains certain restrictions regarding "accredited investors" and non-accredited investors. No specific information is required to be provided to accredited investors. However, non-accredited investors must be advised of and given, on request, all material information given to accredited investors and certain specified investors. There are restrictions on resale of the securities.

(3) Rule 506 provides an exemption from the federal security laws registration requirements provided that the securities are sold to accredited investors and a maximum of 35 other investors. There is no ceiling on the amount of the proceeds. Other restrictions are similar to those of Rule 505.

c. *Regulation A.* Regulation A provides an exemption from registration requirements for certain securities if the offering proceeds during a 12-month period are not more than $5 million. An offering circular is required. However, financial statements are not required to be audited, and periodic (annual and quarterly) reports are not required unless the issuer has more than $10 million in total assets and more than 500 shareholders.

d. *Regulation S-B.* Regulation S-B simplifies the registration and reporting requirements for U.S. or Canadian businesses with revenues of less than $25 million and publicly held stock of less than $25 million. Regulation S-B securities must be registered, and two years' audited financial statements are required. However, the registration forms are simplified, and periodic reporting requirements are either reduced or eliminated.

For more information about these programs, consultants can request a copy of the SEC's free small business information package by calling (202) 551-3460 or go to the SEC's website at **www.sec.gov**/**divisions**/**corpfin**/**forms**/**smallbus.shtml**.

SCOR Form. The Small Corporate Offering Registration (SCOR) Form is a simplified "question and answer" registration form (Form U-7) that companies may use in certain jurisdictions as the disclosure document for investors when relying on Rule 504 for a federal registration exemption. The model SCOR Form (Form U-7) is a rather long document and contains information about the company; its risk factors, management (including management relationships, transactions, and remuneration), directors, and shareholders; the securities being offered (including offering price, use of proceeds, dividends, distributions, and redemptions); litigation; tax aspects; financial statements; and management discussion and analysis of certain relevant factors. Nearly all states have adopted laws or regulations that allow issuers to use SCOR filings to satisfy disclosure obligations in certain offerings. To assist small businesses, some states coordinate SCOR or Regulation A filings through a program called the "Coordinated Review Program" (also known as a "Regional Review"). Companies seeking additional information on SCOR, Regional Reviews, or the issuer's manual should contact NASAA at:

North American Securities Administrators Association
(202) 737-0900
www.nasaa.org

Direct Placement Loans. Direct placement loans are long-term loans usually obtained from institutional investors such as life insurance companies and pension funds. The loan period is typically from 10 to 20 years, and the interest rate may be fixed or variable. In some cases, the lender is given an opportunity to participate in the growth of the company (an "equity sweetener") in return for a lower interest rate.

Mortgage Loans. Mortgage loans are not a big financing source in the construction industry because many construction businesses do not have large physical properties to serve as collateral for the mortgage. When made, they may be based on the value of the property financed or on a combination of the value of the property and the income stream expected over the life of the mortgage. In many cases, the lender only provides a five-year or ten-year mortgage, but payments are based on a 20-year mortgage. This results in a large balloon payment at the end of the mortgage term that must be paid or refinanced. Thrift institutions, such as mutual savings banks and savings and loan associations, provide mortgage loans with terms of 20 to 25 years and fixed interest rates, although variable rates are common.

Layered Financing. A layered financing arrangement uses several financing sources at one time. Layered financing should be considered if a single financing source fails to meet the contractor's needs. For example, a bank may be unwilling to provide the total amount of financing the contractor needs. However, a smaller amount of debt financing from the bank may be combined with some type of equity financing. In addition, the company could add another financing "layer," such as leasing.

Layered financing may be attractive to potential financing sources because it allows them to share financing risks. Thus, it may be an especially attractive way for start-up companies to obtain debt financing from banks that would not ordinarily be willing to assume all the financing risks. Combining debt with equity financing also allows the contractor to reduce the amount of equity being given up. However, obtaining layered financing can be time-consuming and complex since the contractor is pursuing multiple financing sources with differing requirements at the same time.

Before approaching potential financing sources in a layered financing arrangement, the contractor should determine which types of financing best suit its needs and how much of each type of financing is needed. Next, the contractor should prepare one comprehensive financing proposal to present to each potential financing source. The proposal should be designed to meet the standards of the financing source with the most stringent requirements. When presenting its financing proposal, the contractor should inform each potential financing source that a layered financing arrangement is being sought. Lenders may be able to help the contractor contact potential equity investors (and vice versa). Likewise, if lenders know the potential equity investors or their reputation (or vice versa), they may be more willing to commit to the financing because they know of the other parties' involvement. Furthermore, informing a lender that the contractor is also seeking equity financing may influence the lender's decisions regarding the loan amount, terms, and covenants.

Choosing among Financing Alternatives. It may be difficult for a client to choose from such a wide array of financing. The consultant can help the client make an informed and sound choice by acquainting the client with the nature, advantages, and disadvantages of various types of financing that may be relevant to the client's circum-

stances. In some cases, the client may have a reason for selecting a particular type or source of financing that takes precedence over purely financial considerations. For example, the company might decide to seek a bank loan from its bank because of a desire to establish credit for possible future borrowings or to establish a good relationship with, or demonstrate loyalty to, its banker. In those cases, the company might decide to obtain financing from its bank despite the fact that marginally better financing may be available elsewhere. However, in most instances, after clearly inappropriate alternatives are eliminated, several possibilities remain. One approach is to rank the alternatives in (a) descending order of likelihood that the financing type and specific sources provide the desired funds, and (b) descending order of relative desirability of the finance type and source. The two rankings should converge at one or a few financing types and sources to pursue.

Choosing among Lenders. After the company has selected a type of financing, it may have to choose among lenders. Some companies automatically choose the lender with the lowest total cost. However, all of the relevant factors should be considered. Other criteria the company might consider include:

a. Lender's size and ability to meet future needs.

b. Lender's knowledge of the borrower's business.

c. Lender's speed of making credit decisions (especially when obtaining a line of credit or other financing that must be renewed).

d. Loan officer's status in the organization and the frequency with which loan officers are changed.

e. Types of costs and commitments imposed. (For example, some companies prefer not to maintain a compensating balance.)

f. Lender's flexibility in responding to special requests.

The company can use the Internet to assist in researching potential financing sources. Some websites contain reference material to assist the user in making better decisions about loan financing and also give the user the opportunity to apply online for loans and lines of credit.

Interviewing Potential Lenders. After considering the factors discussed above and narrowing the pool of potential lenders, discuss the loan with the viable lenders to determine which one offers the best deal for the borrower. At this stage, it is helpful to interview potential lenders *before* filling out a loan application. That way, the company can avoid having a loan rejection or numerous credit inquiries on its credit report if the lender is not interested in the business or the collateral being offered. The interview process also allows the borrower to compare terms before filling out an application.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Bryan Construction is planning to expand its plant as business grows. Which of the following types of financing is best suited to Bryan Construction's needs?

    a. Repackage existing property with new property as collateral for a loan.

    b. Finance the additional holding period.

    c. Increase it's line of credit to fund the increase in monthly expenses.

    d. Long-term financing to fund increased retention.

14. What financing term is most appropriate for a company to use when acquiring machinery and equipment that will have an anticipated useful life of four years?

    a. Short-term financing.

    b. Medium-term financing.

    c. Long-term financing.

    d. Any financing term is appropriate.

15. If the client wants to acquire an asset that will not generate enough cash to repay the funds needed to acquire it, but believes that the asset is necessary, the client should do which of the following?

    a. Reconsider whether the asset is needed.

    b. Immediately cease all efforts to acquire the asset.

    c. Seek short-term financing to offset the loss anticipated.

    d. Pursue equity funding to acquire the asset.

16. Seasonal lines of credit are used by seasonal construction businesses to obtain working capital during certain months of the year. To be successful in obtaining seasonal lines of credit, contractors must usually pledge all of the following assets as collateral **except**:

    a. Accounts receivable.

    b. Inventory.

    c. Long-term assets.

17. Which of the following statements regarding the various lines of credit is most accurate?

    a. Most real estate constructions contractors use the nonrevolving credit line.

    b. Seasonal committed lines of credit remain available during tough economic times.

    c. Revolving lines of credit must all be paid before borrowing additional money.

18. Which of the following statements regarding asset-based lenders is correct?

    a. Construction in progress is considered inventory that is financed by asset-based lenders.

    b. Asset-based lenders provide contractors an opportunity to generate working capital, but not cash, from their heavy equipment and scrap metals.

    c. Asset-based lenders will make loans to companies that lack strong cash flow.

    d. Asset-based lenders never accept collateral that is not attractive to banks.

19. Which of the following statements concerning new and used machinery and equipment loans is accurate?

    a. They are generally structured as term loans secured by property or investments.

    b. Borrowers generally repay the loans in monthly or quarterly installments over one to ten years.

    c. Most banks will normally advance 70% to 90% of the fair market value of new machinery or equipment.

    d. Most banks will normally advance 50 to 75% of the quick sale value of used machinery or equipment.

20. Clay Construction Company has secured a Small Business Administration (SBA) guaranteed loan to purchase a piece of real estate for its business operations. The maturity of this SBA guaranteed loan will likely be:

    a. 3 to 5 years.

    b. 5 to 10 years.

    c. 10 to 25 years.

    d. Up to 25 years.

21. Which of the following statements regarding equity financing is correct?

    a. Equity financing is generally more expensive than debt financing.

    b. Interest cost is relatively low with equity financing.

    c. Equity generally must be repaid with equity financing.

    d. A larger equity base through equity financing makes it easier to obtain credit.

22. The Securities and Exchange Commission (SEC) has developed programs to make public offerings of securities easier for small businesses by reducing the securities registration and periodic reporting requirements. Which of these programs provides an exemption from registration requirements for certain securities if the offering proceeds during a specified period of time do not exceed a predetermined dollar limit and includes an offering circular?

    a. The intrastate offering exemption.

    b. Regulation D.

    c. Regulation A.

    d. Regulation S-B.

23. Layered financing is one long-term financing that can be considered. Which of the following statements accurately reflects the circumstances surrounding layered financing?

    a. A layered financing arrangement uses several financing sources consecutively.

    b. Layered financing is often more attractive to potential financing sources.

    c. Even when a single financing source meets the contractor's needs, layered financing is preferable.

    d. Obtaining layered financing is generally a short and simple process.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Bryan Construction is planning to expand its plant as business grows. Which of the following types of financing is best suited to Bryan Construction's needs? **(Page 258)**

    a. Repackage existing property with new property as collateral for a loan. [This answer is correct. If Bryan Construction has plans to expand its property, plant, and/or equipment, it may be advisable to repackage existing property with new property as collateral for a loan rather than just financing the current acquisitions.]

    b. Finance the additional holding period. [This answer is incorrect. Financing of the additional holding period would apply if Bryan Construction decided to increase its inventory or buy materials early to protect itself from price increases.]

    c. Increase its line of credit to fund the increase in monthly expenses. [This answer is incorrect. Bryan Construction would likely want to increase its line of credit to fund the increase in monthly expenses on the project that will occur before customer payment is received if it has plans to increase revenues.]

    d. Long-term financing to fund increased retention. [This answer is incorrect. Long-term financing to fund increased retention is another consideration when increasing its line of credit to fund the increase in monthly expenses on the project that will occur prior to receipt of customer payment.]

14. What financing term is most appropriate for a company to use when acquiring machinery and equipment that will have an anticipated useful life of four years? **(Pages 259, 263)**

    a. Short-term financing. [This answer is incorrect. Since the life of the machinery and equipment being acquired is anticipated to have a useful life of four years, short-term financing would not be appropriate due to the fact that short-term financing is for periods less than one year.]

    b. Medium-term financing. [This answer is correct. Medium-term financing is the best length of financing to use for acquiring machinery and equipment with an anticipated useful life of five years since medium-term financing covers a term of one to five years.]

    c. Long-term financing. [This answer is incorrect. The life of the machinery and equipment a company intends to acquire is not anticipated to be greater than five years, therefore long-term financing would not be the most appropriate term to seek.]

    d. Any financing term is appropriate. [This answer is incorrect. The life of an acquired asset should at least equal the term of the financing needed to acquire it. Therefore, the financing term should be closely tied to the anticipated life of an acquired asset and use of a variety of financing terms would not be appropriate.]

15. If the client wants to acquire an asset that will not generate enough cash to repay the funds needed to acquire it, but believes that the asset is necessary, the client should do which of the following? **(Page 260)**

    a. Reconsider whether the asset is needed. [This answer is incorrect. The client should not abandon the asset that is viewed as necessary due to loan problems.]

    b. Immediately cease all efforts to acquire the asset. [This answer is incorrect. If the asset is needed by the client, discontinuing efforts to acquire it will not solve the client's problem.]

    c. Seek short-term financing to offset the loss anticipated. [This answer is incorrect. Short-term financing would not solve the problem of the acquired asset not generating enough cash to repay the funds borrowed.]

    d. Pursue equity funding to acquire the asset. [This answer is correct. If the asset to be acquired will not generate enough cash to repay the funds needed to acquire it, a source other than a loan should be considered, such as equity funding.]

16. Seasonal lines of credit are used by seasonal construction businesses to obtain working capital during certain months of the year. To be successful in obtaining seasonal lines of credit, contractors must usually pledge all of the following assets as collateral **except**: **(Page 262)**

    a. Accounts receivable. [This answer is incorrect. One of the assets contractors must usually pledge as collateral to obtain working capital under seasonal lines of credit is their accounts receivable.]

    b. Inventory. [This answer is incorrect. Inventory is one of several assets seasonal construction businesses must pledge as collateral under seasonal lines of credit to obtain working capital.]

    c. Long-term assets. [This answer is correct. Seasonal construction businesses do not have to pledge long-term assets to obtain working capital under seasonal lines of credit.]

17. Which of the following statements regarding the various lines of credit is most accurate? **(Page 262)**

    a. Most real estate constructions contractors use the nonrevolving credit line. [This answer is incorrect. There are three types of credit lines: seasonal, revolving, and nonrevolving. A revolving credit line is the most common type used in the construction industry.]

    b. Seasonal committed lines of credit remain available during tough economic times. [This answer is correct. If a seasonal line of credit is noncommitted, the availability of funds is not guaranteed. Unlike noncommitted lines, seasonal committed lines of credit guarantee that credit will be available even during the tightest economic times, but the fees are typically higher (sometimes as high as 1/2% to 1%).]

    c. Revolving lines of credit must all be paid before borrowing additional money. [This answer is incorrect. Repayments of principal and interest are made monthly, and amounts repaid are available to be borrowed again.]

18. Which of the following statements regarding asset-based lenders is correct? **(Page 263)**

    a. Construction in progress is considered inventory that is financed by asset-based lenders. [This answer is incorrect. Construction in progress is *not* considered inventory for financing purposes.]

    b. Asset-based lenders provide contractors an opportunity to generate working capital, but not cash, from their heavy equipment and scrap metals. [This answer is incorrect. Asset-based lenders provide contractors an opportunity to generate both working capital *and cash* from their heavy equipment and scrap metals.]

    c. Asset-based lenders will make loans to companies that lack strong cash flow. [This answer is correct. Asset-based lenders will make loans to companies that lack strong cash flow or are highly leveraged.]

    d. Asset-based lenders never accept collateral that is not attractive to banks. [This answer is incorrect. In some cases, asset-based lenders accept collateral that is not attractive to banks.]

19. Which of the following statements concerning new and used machinery and equipment loans is accurate? **(Page 264)**

    a. They are generally structured as term loans secured by property or investments. [This answer is incorrect. New and used machinery and equipment loans are generally structured as term loans secured by specific *machinery or equipment*.]

    b. Borrowers generally repay the loans in monthly or quarterly installments over one to ten years. [This answer is correct. Borrowers generally repay the loans in monthly or quarterly installments over one to 10 years, depending on the estimated life of the collateral.]

    c. Most banks will normally advance 70% to 90% of the fair market value of new machinery or equipment. [This answer is incorrect. Most banks will normally advance 70% to *95*% of the fair market value of new machinery or equipment.]

d. Most banks will normally advance 50 to 75% of the quick sale value of used machinery or equipment. [This answer is incorrect. Most banks will normally advance 50% to *80*% of the quick sale value of used machinery or equipment. The quick sale value of used machinery or equipment is established by banks based on values that are listed in trade or industry guides available from equipment dealers.]

20. Clay Construction Company has secured a Small Business Administration (SBA) guaranteed loan to purchase a piece of real estate for its business operations. The maturity of this SBA guaranteed loan will likely be: **(Page 264)**

a. 3 to 5 years. [This answer is incorrect. A loan of 3 to 5 years would classify as a medium-term loan. Real estate financing is generally in the form of a long-term loan.]

b. 5 to 10 years. [This answer is incorrect. A SBA guaranteed loan with a maturity of 5 to 10 years is generally for working capital loans.]

c. 10 to 25 years. [This answer is incorrect. A loan of 10 to 25 years guaranteed by the SBA is generally made for machinery and equipment.]

d. Up to 25 years. [This answer is correct. A SBA guaranteed loan for real estate financing generally has a maturity of up to 25 years.]

21. Which of the following statements regarding equity financing is correct? **(Page 264)**

a. Equity financing is generally more expensive than debt financing. [This answer is incorrect. Equity financing is generally cheaper than debt financing.]

b. Interest cost is relatively low with equity financing. [This answer is incorrect. There is no interest cost with equity financing.]

c. Equity generally must be repaid with equity financing. [This answer is incorrect. Equity usually does not have to be repaid.]

d. A larger equity base through equity financing makes it easier to obtain credit. [This answer is correct. A larger equity base may make it easier to obtain credit and make a contractor's financial position more favorable toward sureties.]

22. The Securities and Exchange Commission (SEC) has developed programs to make public offerings of securities easier for small businesses by reducing the securities registration and periodic reporting requirements. Which of these programs provides an exemption from registration requirements for certain securities if the offering proceeds during a specified period of time do not exceed a predetermined dollar limit and includes an offering circular? **(Page 266)**

a. The intrastate offering exemption. [This answer is incorrect. The intrastate offering exemption, Section 3(a)(11) of the Securities Act, exempts from registration any security that is part of an issue offered and sold only to residents of the state in which the company resides and does business.]

b. Regulation D. [This answer is incorrect. Regulation D provides exemptions from registration in Rules 504, 505, and 506.]

c. Regulation A. [This answer is correct. Regulation A provides an exemption from registration requirements for certain securities if the offering proceeds during a 12-month period are not more than $5 million and include an offering circular.]

d. Regulation S-B. [This answer is incorrect. Regulation S-B simplifies the registration and reporting requirements for U.S. or Canadian businesses with revenues of less than $25 million and publicly held stock of less than $25 million.]

23. Layered financing is one long-term financing that can be considered. Which of the following statements accurately reflects the circumstances surrounding layered financing? **(Page 267)**

    a. A layered financing arrangement uses several financing sources consecutively. [This answer is incorrect. A layered financing arrangement uses several financing sources *at one time*.]

    b. Layered financing is often more attractive to potential financing sources. [This answer is correct. Layered financing may be attractive to potential financing sources since it allows them to share financing risks.]

    c. Even when a single financing source meets the contractor's needs, layered financing is preferable. [This answer is incorrect. Layered financing should be considered if a single financing source fails to meet the contractor's needs.]

    d. Obtaining layered financing is generally a short and simple process. [This answer is incorrect. Obtaining layered financing can be time-consuming and complex due to the fact that the contractor is pursuing multiple financing sources with differing requirements at the same time.]

Preparing a Financing Proposal

After a client has decided on a financing plan to pursue, the client may want the consultant's assistance in identifying information to include in a financing proposal package to submit to potential funding sources. The client may also request that the consultant prepare some of the information. The financing proposal should accurately and effectively present the client's case. The client naturally wants to present the company situation in the most favorable light possible, but that does not mean unfavorable information will be omitted or glossed over. Rather, such information should be presented in a straightforward manner including, if possible, management plans for addressing the problem.

The financing proposal should include information that may be expected to help a potential lender make the important assessment of whether the loan principal and interest will be paid when due. Lending institutions have identified the following factors in descending order of importance in making those assessments:

a. Quality of management.

b. Risk of default.

c. Size of loan relative to size of business.

d. Debt-to-equity ratio.

e. Intended purpose of loan.

f. Firm's liquidity position.

g. Type of repayment plan.

h. Type of collateral available.

i. Past profit trend.

j. Future profit trend.

k. Stability of profits.

l. Ease of sale of the company's assets in case of liquidation.

m. Possible future profitable relations with borrower.

n. Loan activity at other banks.

o. Loan term.

p. Availability of audited financial statements.

q. Length of lender's relationship with borrower.

r. Expected size of deposits with lender.

s. Rate of return borrower earns on assets.

Thus, it is probably a good idea for the financing proposal to include information about these factors or information that can be expected to provide a basis for reaching a conclusion about these factors.

Depending on the financing they provide, lenders may have specific concerns besides those listed above, or they may give more weight to some factors than other lenders do. For example, finance companies, which concentrate

on collateralized loans, are especially concerned with the value of collateral. Such specific concerns and the specific type of loan sought influence the information a lender wants to see in a financing proposal. For example, a proposal for a collateralized loan should include details about the property serving as collateral, such as current market value of fixed assets; a proposal for an unsecured working capital loan should include detailed lists of contracts in progress, inventory (if significant), and aged receivables.

The typical contents of a loan proposal may be classified as follows:

a. Proposal summary.

b. Management profiles.

c. Description of the business.

d. Specific information about the loan requested.

e. Company financial statements—current, historical, and prospective.

f. Personal financial statements of guarantor, if any.

If the company has a business plan, it should accompany the proposal, or relevant information in the business plan (for example, the description of the business and management) may be incorporated into the proposal. Some lenders have standard loan request packages applicants must complete. The standard packages may vary somewhat from the contents recommended above, but ordinarily they are substantially similar. The specific items are discussed below.

Proposal Summary. A summary page simply identifies the company seeking financing and the amount, type, and purpose of loan requested. It may also list information such as the repayment terms and the company's source of repayment; proposed security or collateral; the name of any proposed guarantors, including a description of how those individuals are related to the company; and a person in the company the financing source may contact about the requested financing. The summary may be presented in the form of a transmittal letter addressed to the lender and signed by an appropriate company official. Also, the summary page may include a table of contents to the various parts of the financing proposal.

Management Profiles. As previously noted, lenders consider quality of management the most important factor in deciding whether to grant a loan. Essentially, providers of funds want information that helps them assess management's character (honesty and reliability) and ability to manage the business so it is profitable and meets its financial obligations. The quality of management is especially important for a new business where historical results are not available as an indicator of past management performance. A good financing proposal should include the names and functional responsibilities of each key member of management. At a minimum, it should be clear who fills the roles of the chief operating officer, marketing/sales director, and chief financial officer. If the business owner fills one or more of these roles, that fact should be clear. An organization chart may be helpful in portraying the overall organization of the company and the respective positions of the management team members. Basic details and relevant experience, education, skills, and significant relevant accomplishments in the company or other companies (for example, set up new sources of revenue or obtained new customers) should be disclosed about each key member of management. The objective is to provide relevant information that indicates the executive's capability in managing the business. If key members of management are nearing the age of retirement, the proposal should also describe the company's plan of succession.

Description of the Business. This part of the proposal should give the lender an understanding of the company's style, nature, history, and activities, and how the company fits into its market. The information should allow the lender to assess the company's business risks, including its ability to ultimately collect its revenue. A contractor should indicate its primary types and sources of contracts (for example, if a contractor is principally involved in government contracts, a lender might feel more comfortable that the contractor will eventually be paid—even if payment might take somewhat more time). The description of the business, which need not exceed a few pages, should include information such as the following:

a. Legal structure of the company; for example, proprietorship, partnership, etc.

b. Type of contractor; highway contractor, general building contractor, etc.

c. Primary types of contracts or services, including any unique features of those contracts or services, and major contracts completed.

d. Current stage of development, for example, preoperating, young and growing company, mature and stable, and summary of growth.

e. Description of the market and the company's market position, for example, local, national, or international, industry growth trends, customer base and competitors.

f. Employees (number and types, whether unionized, pay structure, compensation or incentive proposals, labor shortages, fluctuations in workforce levels, etc.), and significant union agreements, contracts, pension plans, contingent liabilities, etc.

g. Significant company goals, objectives, or challenges faced.

h. Competitive advantage (that is, what sets the company apart from its competitors), and description of any unique construction methods that might indicate increased competitiveness.

Much of the information listed above, as well as other information about the company that might be included in the proposal, is provided in the "Construction Company Background Information Form", which the consultant may have prepared for a previous consulting or accounting engagement or at the pre-engagement stage of the current engagement.

Specific Information about the Loan Requested. This section of the financing proposal includes a discussion of matters related to the loan [such as the purpose, amount, and intended repayment (term) of the loan] and collateral offered, if a secured loan is sought. It provides an opportunity for a more detailed discussion of those matters than the brief information listed on the proposal summary page.

Purpose of the Loan. The purpose of the loan should be described in specific terms. Rather than "additional working capital" or "to purchase construction equipment," the specific purpose should be given, such as,"to purchase two additional dump trucks to enable the company to enter into larger excavation contracts." The discussion of loan purpose may include a general statement of the expected benefit if the loan is granted and the expected effect on the company if it is denied.

Amount of the Loan. The amount requested should be the amount deemed necessary. Some loan applicants request more than they need, believing the loan approved will be less than requested. Others ask for less than they need, believing a smaller loan is more easily approved. Either alternative can lead to trouble. If too large or too small a loan is granted based on an inappropriate request, the result may be unnecessarily high interest costs or inadequate funding for the project. It is difficult to overstate or understate the loan needs in a well-prepared proposal because the support for the amount requested should be presented.

Repayment of the Loan. The plan for repayment of the loan should describe how cash flows will increase sufficiently, as a result of the loan, to permit repayment. The description might make reference to other sections of the proposal that give detailed cash flow projections. A break-even computation might be presented to show the time necessary to repay a loan for machinery or equipment. Information supporting the expected repayment terms (and the amount of the loan as well) probably will have been prepared in an earlier stage of the financing engagement, that is, when determining the client's financing needs, and that information can be summarized in this section of the financing proposal.

Lenders generally want a second repayment source in case the cash flow is less than anticipated or unexpected events and circumstances arise. The second source generally is not directly connected with operations, for example, liens on other assets or a personal guarantee.

Collateral. A small business should expect that lenders may require collateral for a loan. This may include a lien on new machinery or equipment to be acquired with the loan as well as on existing property. The collateral section of

the proposal should present the client's plans for offering collateral, and it might include a list of the machinery and equipment in use at the company and an indication of which items are unencumbered, encumbered, and leased (and thus not available for collateralization). The list should include the equipment cost and market value.

Personal Guarantees. Many banks require personal guarantees of small business loans. If a guarantee is expected to be required, the proposal should identify any potential guarantors and describe their relationship to the business. The proposal should also provide financial information about the guarantors.

Other Information. The loan proposal should discuss any other information specific to the loan requested. For example, the client might be aware of interest rates or restrictive covenants (such as minimum working capital or debt/equity requirements) or restrictions on dividend payments, mergers, or acquisitions that apply to the loan requested. In such a case, the proposal should indicate that management is aware of such provisions and has considered their effect on the company and its willingness and ability to be bound by the requirements. Other information the client might want to include (or the lender might request) includes copies of insurance policies and significant contracts or agreements, sample advertisements, and articles of incorporation or partnership agreements.

Company Financial Statements. Current, past, and prospective financial information naturally is an important part of a financing proposal. Every lender/investor wants to see that information, though the number of years and detail of supporting financial data varies by the nature of the financing and the company's situation, for example, availability of past years' statements and lender/investor preferences. If the specific potential lenders/investors have been identified, it may be prudent to inquire of their specific requirements before preparing the financial section. The CPA consultant will also need to ensure that all of the applicable independence and documentation requirements of Ethics Interpretation 101-3, "Performance of Nonattest Services," are met.

Historical Financial Statements. Generally, lenders want to see at least three years of historical financial statements and may request interim statements if the latest annual statements are more than three to six months old. Unless requested otherwise by a lender, it is generally best to provide GAAP-basis basic financial statements—that is, balance sheet, income statement, statement of retained earnings or changes in stockholders' equity (or partner's capital), statement of cash flows, and notes to the financial statements.

The "Checklist of Contents for a Construction Contractor Financing Proposal" lists additional information, explanations, and details of items in the basic financial statements that it may be appropriate to present. In addition to those items, it may be appropriate to present a summary of insurance coverage, details of marketable securities or other investments, including current market values, and explanation of any losses or unusual operating results. Also, notes to the financial statements or supplemental information should include detailed information about the client's existing debt, including date and original amount of debt, interest rate, payment terms, current balance, and collateral pledged. The client should also disclose details of any lease obligations, loans from owners or other related-party debt, and loss contingencies, as well as any significant events or accounts underlying the financial statements (for example, highly depreciated assets with significant value or debt owed to owners that could be subordinated to bank debt).

Some of this information may be costly to prepare or obtain, for example, current values of investments or fixed assets. Thus, consideration should be given to the relevance of the information, to the type of financing being sought, and to the likelihood that the lender will request such information. It may be wise to inquire as to the lender's requirements before preparing or obtaining such information if it is not readily available.

A financial statement review may be adequate for lending purposes for many smaller contractors. Larger construction contractors may be required to provide audited financial statements. Compiled financial statements are generally acceptable only on an interim (for example, quarterly) basis. A consulting client should always ask if the lender would be willing to accept "lower assurance" financial statements (for example, substituting reviewed financial statements for audited financial statements) if the client does not already have the requested financial statements.

Prospective Financial Information. Lenders are likely to be as interested in prospective financial information as in historical financial statements, if not more so. Lenders are interested in prospective results of operations and financial position so they can assess how the loan will affect the company, for example, whether the company will

be able to meet any restrictive covenants the lender might impose, such as minimum working capital and debt/equity requirements. Lenders are especially interested in prospective cash flows because they will provide the means of repaying the loan. Generally, the lender requests prospective information for at least the first year after the financing is received and may request prospective information for the entire period of the loan.

The format of prospective financial information should be consistent with that used for historical financial statements. The prospective presentation should represent management's best knowledge and belief as to conditions it expects will exist and actions it will take if the loan is received. In addition, the client should be sure to disclose the assumptions used in preparing the prospective statements. Since the prospective presentation is expected to be used by third parties, AICPA procedures and reporting rules apply if a CPA assembles the presentation. Essentially, those rules require the CPA to at least compile a prospective presentation and report on it accordingly. Best practices indicate that the AICPA standards for prospective financial information should be applied if the client prepares the prospective presentation and it is presented to the lender on the CPA's letterhead, in the CPA's report jacket, or alongside any historical financial statements the CPA has prepared.

Pro Forma Financial Information. The objective of pro forma financial information is to show what the direct and significant effects on historical information might have been had a consummated or proposed transaction or event occurred at an earlier date. For example, lenders have asked contractors pursuing equipment or real estate refinancings to provide pro forma financial information for the prior fiscal year end depicting the effect of the refinancing. Although such future or hypothetical transactions may appear prospective in nature, pro forma presentations are essentially recast historical financial statements. A practitioner might be engaged to examine or review pro forma financial information, or to perform services that are less than an examination or review (for example, a compilation or assembly).

Financial Ratios. Consideration should be given to including financial ratios in the financing proposal because that information is useful to the lender in making a financing decision. Financial ratio analysis allows a lender to relate one aspect of financial position or operations to another, consider trends over time, and compare the specific company to general industry averages. By computing financial ratios based on prospective financial statements, an assessment can be made of how the desired financing and its expected use affects the company's financial strength. Banks are currently using the debt to equity ratio as a major consideration in making unsecured financing commitments to contractors. The calculation is being made in two ways: total debt to equity and long-term debt to equity. This has made financing from these sources more difficult for engineering and heavy contractors because of their equipment financing debt. Also, smaller contractors that own real estate in the contracting entity have had difficulty meeting lender requirements for additional unsecured financing.

Individual company ratios are usually more meaningful when compared to industry statistics and trends. One of the most popular sources of industry ratios for bankers is *RMA's Annual Statement Studies*, which is published by the Risk Management Association (RMA). RMA's information comes from information provided by banks and is a popular source because it presents ratios across industries in the same format. Trade associations are also excellent sources of comparative financial data for the construction industry. For example, the Construction Financial Management Association (CFMA) publishes the *Construction Industry Annual Financial Survey*, which provides benchmarking information for the construction industry. The survey is organized by type of construction, dollar volume, and geographic region. It also presents information on how the major construction industry sectors operate in areas such as accounting, cash management, bonding, and human resources. Hard copy, CD-ROM, and electronic versions are available. Reduced rates are available to contractors who complete the survey and practitioners assisting a contractor complete the survey.

Personal Financial Statements of Guarantor. Construction industry lenders and underwriters generally require a personal guarantee of the owner(s) of a company. When the loan is personally guaranteed, the financing proposal should include, or the lender may request, personal financial statements of the guarantor (joint statements should normally be prepared if the guarantor is married).

Some consultants prefer that the individual prepare his own personal financial statements if he is capable of doing so and if the lender does not require CPA involvement. The CPA might prefer not to be involved because if the CPA prepares the statements, he or she must at least compile them following the SSARS. Also, the presumption is that a CPA compiling personal financial statements should follow the accounting principles in FASB ASC 274-10

(formerly SOP 82-1, *Accounting and Financial Reporting for Personal Financial Statements*), whereas the individual might be able to take accounting shortcuts that are acceptable to the lender.

Prescribed Forms. Institutional lenders often request loan applicants to present historical or prospective financial statements on preprinted forms or schedules. Forms that might be submitted to a lending institution in connection with a financing request include the Small Business Administration Form 413, "Personal Financial Statement."

Income Tax Return. Company tax returns are not ordinarily included in a financing proposal. Sometimes, however, a lender requests a copy of the tax return if company financial statements are not available or if the lender feels client-prepared financial statements are poorly prepared. A CPA firm might have prepared the company tax return that the client now plans to submit to the lender. Even though the CPA prepared the return and the CPA firm's name appears on the return, SSARS requirements do not apply. However, a SSARS interpretation at AR 9100.31–.32 states that an accountant *may* issue a compilation or review report on a tax return if the applicable performance and reporting requirements are met.

The CPA's Reporting Responsibility for Prescribed Forms. Forms prescribed by a lending institution may be prepared by the client. If the client prepares the forms and the CPA merely reproduces them in a financing proposal, the forms need not be audited, reviewed, or compiled. However, in that situation, it is recommend that the proposal include a caveat stating that the consultant has not compiled, reviewed, or audited the forms and assumes no responsibility for them.

If the CPA prepares a prescribed form, SSARS reporting rules apply to the historical financial statements included in the form. AR 300 provides an alternative form of standard compilation report when the prescribed form or related instructions call for departures from GAAP. The alternative form of report does not enumerate GAAP departures *required by the form*. (A tax return does not qualify as a prescribed form under AR 300.)

CPAs should follow the reporting provisions of the SSARS if (a) the lender requires a review report (AR 300 alternative report applies only to compilations), (b) the form does not call for departures from GAAP, (c) the form is not designed or adopted by the body to which it is to be submitted (for example, the borrower uses the form required by Bank B when requesting a loan from Bank A), (d) the financial statements include GAAP departures not required by the prescribed form, or (e) the financial statements include departures from the requirements of the prescribed form. Also, the CPA is not precluded from issuing a SSARS report in situations where a report under AR 300 could be issued.

AR 300.05, states that the accountant should not sign a preprinted form unless the language in it conforms to the guidance in the SSARS. If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form. It is suggested that the accountant type "See accountant's compilation report" in the prescribed form signature block.

Checklist of Contents for a Financing Proposal. Obviously, the specific details of a financing proposal vary with the particular company, type of financing sought, and potential lender. Thus, this lesson does not illustrate a financing proposal. Nevertheless, the basic contents of financing proposals typically include the elements discussed in this lesson. Exhibit 1-1 lists suggestions for presenting an effective financing proposal.

Exhibit 1-1

Suggestions for Preparing an Effective Financing Proposal

Title Page and Table of Contents

- Use an appropriate cover.
- Include the company's name, address, phone number, the name of the primary company contact, and the revision date on a title page.
- Use tabs for each major section.
- Add a disclaimer stating that the proposal is confidential and not be to reproduced. Alternatively, place the term *confidential* in a header on every page.

Body of the Proposal

- Use charts or other visual aids to make the proposal easy to read and understand.
- Discuss awards or honors the company has won (for example, for quality service, innovation, or market leadership).
- Include photos or samples of the company's work, if possible.
- Include a list of references from customers, suppliers, investors, industry experts, or other knowledgeable sources.

Administrative Matters

- Assign a number to each copy of the proposal and record the recipient's name and telephone number. (Lenders and investors may not return the financing proposal even if they reject the proposal.)
- Use a readable font.
- Number the pages.

* * *

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

24. When a potential lender is making the assessment as to whether the loan principal and interest will be paid when due, which of the following factors identified by lending institutions is deemed the most important in making that assessment?

    a. Type of collateral available.

    b. Type of repayment plan.

    c. Future profit trend.

    d. Past profit trend.

25. One element to include when preparing a financial proposal is specific information about the loan requested. Generally, each lender or investor wants to see _____ of historical financial statements.

    a. The most recent year.

    b. At least two years.

    c. At least three years.

    d. A minimum of five years.

26. Which of the following statements regarding prescribed forms is most accurate?

    a. If a client prepares the forms prescribed by the lending institution, SSARS reporting rules apply to the historical statements included in the form.

    b. The language on the preprinted form must comply with the guidance in SSARS before the accountant can sign it.

    c. CPA's cannot issue a SSARS report in instances where a report under AR 300 could be issued.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

24. When a potential lender is making the assessment as to whether the loan principal and interest will be paid when due, which of the following factors identified by lending institutions is deemed the most important in making that assessment? **(Page 276)**

    a. Type of collateral available. [This answer is incorrect. In assessing whether the loan principal and interest will be paid when due, of the four choices, the type of collateral available is the second most important.]

    b. Type of repayment plan. [This answer is correct. The type of repayment plan is the most important of these four factors to be considered in assessing the likelihood that the loan principal and interest will be paid when due.]

    c. Future profit trend. [This answer is incorrect. Of the choices listed, the future profit trend is the least important factor to consider in determining whether the loan principal and interest will be paid when due.]

    d. Past profit trend. [This answer is incorrect. Past profit trend is the third most important factor of the four choices listed that a potential lend should consider in assessing whether the loan principal and interest will be paid when due.]

25. One element to include when preparing a financial proposal is specific information about the loan requested. Generally, each lender or investor wants to see _____ of historical financial statements. **(Page 279)**

    a. The most recent year. [This answer is incorrect. Each lender or investor generally wants to see the most recent year, but also wants to see other past years also.]

    b. At least two years. [This answer is incorrect. Lenders or investors generally want to see more than just two years of historical financial statements.]

    c. At least three years. [This answer is correct. Generally, lenders want to see at least three years of historical financial statements.]

    d. A minimum of five years. [This answer is incorrect. Lenders or investors do not generally want to see five years of historical financial statements.]

26. Which of the following statements regarding prescribed forms is most accurate? **(Page 281)**

    a. If a client prepares the forms prescribed by the lending institution, SSARS reporting rules apply to the historical statements included in the form. [This answer is incorrect. If a client prepares the forms and the CPA reproduces them in a financing proposal, the forms do not need to be auditing, reviewed, or compiled. However, if the CPA prepares a prescribe form, SSARS reporting rules will apply to the historical financial statements included in the form.]

    b. The language on the preprinted form must comply with the guidance in SSARS before the accountant can sign it. [This answer is correct. According to AR 330.05, the accountant should not sign a preprinted form unless the language in it conforms to the guidance in the SSARS. If the preprinted report is not suitable, the accountant should attach an appropriate report to the prescribed form.]

    c. PA's cannot issue a SSARS report in instances where a report under AR 300 could be issued. [This answer is incorrect. A CPA is not precluded from issuing a SSARS report in situations where a report under AR 300 could be issued per SSARS guidance.]

Negotiating the Financing

After the financing proposal has been prepared and a specific potential lender identified, the client should make plans to negotiate with the lender. Negotiation involves discussing the information in the proposal with the potential lender, that is, information about the company and terms and conditions of the loan. An objective is for both parties to agree to acceptable terms and conditions of the financing. Some of the matters that can be negotiated include—

a. Amount.

b. Interest rate and fees.

c. Term of loan.

d. Repayment schedule, including any skipped payments.

e. Amount and type of collateral.

f. Guarantees—nature and by whom.

g. Restrictive covenants, for example,

   (1) Minimum or compensating cash balance,

   (2) Minimum working capital ratio,

   (3) Minimum equity level,

   (4) Dividend payout limitations,

   (5) Subordination of notes or advances due to stockholders or owners,

   (6) Limitations on salary increases,

   (7) Acquisition of fixed assets,

   (8) Acquisition of additional debt, and

   (9) Business sale, merger, or acquisition.

h. Acquisition of additional insurance on life of owner, key manager, or guarantor.

i. Periodic financial reporting and extent, if any, of CPA involvement, that is, compiled, reviewed, or audited financial statements.

Recently, lenders have been imposing more restrictive terms and conditions. The client should be aware of the types of terms and conditions that might be imposed and determine a preferred, acceptable, and unacceptable position for each potential negotiating point.

Guarantees. When negotiating, the borrower should give serious thought to the individuals required to guarantee the loan, as well as to the nature of the guarantees. Guarantees come in varying forms:

a. *Unlimited Guarantee.* With an unlimited guarantee, the guarantor is personally liable for the entire amount of the loan.

b. *Joint and Several Guarantee.* With a joint and several guarantee, two or more individuals are each responsible for the entire amount of the loan.

c. *Limited or Proportionate Guarantee.* With a limited or proportionate guarantee, the guarantor is liable for less than the full amount of the loan.

d. *Time Guarantee.* With a time guarantee, the guarantee can be reduced or removed after certain conditions are met, such as after a specified time period has expired or after the company has met certain performance targets.

Bankers view such a guarantee as a personal commitment to the business and are rarely willing to negotiate on this point. However, if collateral is sufficient as a secondary repayment source, the owner should at least request the bank to eliminate the personal guarantee requirement. If the bank insists on the owner's personal guarantee, the borrower should try to negotiate a limited guarantee or a guarantee that releases the guarantor after certain targets are met.

CPA Participation in Negotiations. The client might ask the consultant to be present at the negotiations to explain financial information in the proposal, if necessary, or help demonstrate different repayment plans. The consultant should be careful not to take on the role of management or agent for the client. The consultant can advise the client about matters that might arise during the negotiations, but only the client should make decisions or commitments. Also, the consultant should be careful not to provide any inappropriate assurances about financial presentations in the proposal, and not appear to associate himself with any client-prepared financial information submitted. Finally, the consultant should keep in mind the confidentiality requirements of the AICPA and potentially state boards of accountancy. Rule 301 of the *Code of Professional Conduct* prohibits disclosure of confidential information except with the consent of the client. Thus, if the consultant meets with the lender, he should first make sure the client consents to his revealing any information relevant to the loan process.

Postnegotiation Services. If the financing is denied, the consultant might help the client do the following:

a. Review the funding request in the loan proposal and consider the specificity of the loan amount requested, whether the primary purpose (such as asset acquisition) and underlying purpose (such as company growth) for use of the funds were clearly described, and whether the loan amount was supported by clear computations.

b. Ask the lender exactly why the loan was rejected, review the lender's explanation of the reason, and try to determine any underlying reasons for the rejection.

c. Consider whether a bank loan really is the appropriate type of financing source, and consider other banks that make loans to companies in the construction industry.

d. Before pursuing financing with another bank, evaluate a potential loan officer's experience, especially in the construction industry.

e. Determine whether the owner and management team effectively communicated the company's situation during the presentation of the loan proposal, and consider using the consultant in future presentations.

f. Assess whether the historical and prospective financial information (particularly cash flow information) was presented clearly and concisely, and consider adding (1) supplemental information that presents additional explanations or details of specific accounts to help the lender better understand the financial statements, or (2) a brief trend analysis of historical cash flows to help explain and support any prospective financial information.

g. Consider using creativity in negotiating with a new potential lender, such as identifying other financing to add subordinate capital to any new senior bank loans proposed, developing alternative secondary repayment sources in lieu of sufficient collateral, or selling the company or taking the firm public in the future to create cash flows to repay the bank.

The consultant might also help the client revise the financial proposal, for example, the amount requested, the business plan, suggesting an SBA loan guarantee and its advantages to the bank, etc., so that the proposal might be acceptable to a lender. Once financing is granted, the consultant might assist the client in reviewing the closing

documents and determining that the terms and conditions are the ones to which the client agreed in the negotiations.

Engagement Activities and Administration

Pre-engagement planning, engagement conduct and control, workpapers, engagement review, reporting, and follow-up considerations are generally relevant to all types of consulting engagements. The following activities and administrative and reporting matters specifically relate to a financing services engagement:

a. Reaching an understanding with the client (engagement letter).

b. Controlling the engagement with a detailed work program.

c. Obtaining a representation letter.

d. Preparing a closing letter or a transmittal letter submitted to the client and other reports to accompany a financing proposal.

Client Understanding—The Engagement Letter. Authoritative standards for consulting services engagements require that the consultant reach an understanding with the client about the nature, scope, and limitations of the engagement. In a financing services engagement, particular matters about which an understanding should be reached include the following:

a. *Scope of Services to Be Provided.* Since the process of obtaining financing has several phases, the client and consultant should agree whether the engagement will be limited to studying the client's financing needs and potential financing sources, or will include advising on and preparing some or all of the financing proposal or participation in negotiations. If possible, information that the consultant will prepare should be identified, for example, a business plan, prospective financial statements, etc. Any necessary services related to information the consultant prepares or is associated with should be described, for example, compilation of historical or prospective financial statements.

b. *Limitations.* The consultant should be sure the client understands that the consultant does not guarantee that financing will be obtained.

c. *Confidentiality.* If the engagement includes consultant participation in negotiations with potential lenders, the client should give the consultant permission to disclose confidential information during the negotiations, for example, information not in the financing proposal relevant to questions the lender might ask.

d. *Completion of the Engagement.* A clear understanding should be reached concerning when the engagement will be deemed completed. For example, the engagement might be considered completed when the proposal is completed or when negotiations have been concluded with a designated lender. In such an arrangement, if financing is not obtained and the client wants to prepare another proposal or approach other lenders, the consultant's service is considered another engagement, subject to new engagement arrangements. The consultant might also consider providing a list of deliverables (such as a draft of the financing proposal) and asking the client to acknowledge the receipt of those deliverables.

e. *Fees.* The basis for the fee should be clearly described, for example, by indicating that they are based on hourly billing rates, hours incurred, and expenses. If the engagement includes several phases, the fee for each phase might be estimated, particularly if the engagement includes preparation of materials in connection with an SBA loan. Also, the consultant should keep in mind that contingent fees and commissions may be prohibited.

SSCS No. 1 does not require a *written* understanding with the client, but it is recommended that an engagement letter be obtained containing the matters mentioned in the preceding paragraph, especially if the engagement will include reporting on historical or prospective financial information. SSCS No. 1 requires that changes in the services to be performed also be communicated to the client.

Detailed Engagement Work Program. Using a detailed work program helps in organizing a financing services engagement and in the supervision of firm assistants, if any, involved in the engagement. Modifications and additional details should be added to the program as appropriate for the specific circumstances of a particular engagement.

Representation Letter. A representation letter serves to confirm oral representations the client makes to the consultant during the engagement. Some consultants do not obtain representation letters if the engagement is limited to analyzing financing needs and sources. As a general rule, best practices indicate that a representation letter should be obtained whenever the consultant prepares all or some of the financing proposal because the proposal is used by third parties. Also, AICPA standards require that a CPA obtain signed representations when compiling a financial projection or reviewing or auditing historical financial statements.

Reporting on a Financing Services Engagement. SSCS No. 1 does not require a *written* report on a consulting services engagement, but only communication of "(a) conflicts of interest that may occur . . . , (b) significant reservations concerning the scope or benefits of the engagement, and (c) significant engagement findings or events." If a financing services engagement is limited to analyzing and advising the client on financing needs and sources, a closing letter may suffice to signal that the engagement has ended and to refer to oral presentations, communications, or analyses previously furnished to the client.

If the engagement includes the consultant's preparing and submitting to the client all or part of the financing proposal, it is recommended that the consultant prepare a transmittal letter to accompany the proposal submitted to the client. The transmittal letter should include any assumptions, recommendations, or limitations not included in the financing proposal. (Note, however, that a financing proposal should disclose information and explanations that would typically be relevant to a potential lender.) Also, in the transmittal letter or in one or more separate reports, the CPA must appropriately report on any historical or prospective financial statements the CPA prepared or that are included in the document the CPA submits to the client. Guidance on the CPA's reporting obligations for the following financial information that might be included in a financing proposal is provided in this lesson:

a. Historical financial statements.

b. Prospective financial information.

c. Personal financial statements.

d. Tax return.

e. Financial statement included in a prescribed form, for example, a loan application.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

27. When the borrower is negotiating financing, he or she should seriously consider the individuals required to guarantee the loan and the nature of the guarantees. There are various forms of guarantees. With which of the following forms of guarantees is the guarantor liable for less than the full amount of the loan?

    a. Unlimited guarantee.

    b. Joint and several guarantee.

    c. Limited or proportionate guarantee.

    d. Time guarantee.

28. Which of the following actions should the CPA avoid when participating with the client in negotiating the financing?

    a. Assume the role of agent for the client.

    b. Explain financial information in the proposal.

    c. Assist in demonstrating different repayment plans.

    d. Advise client regarding matters that arise during negotiations.

29. Disclosure of confidential information except with the consent of the client is prohibited by _____ of the *Code of Professional Conduct*.

    a. Rule 101.

    b. Rule 201.

    c. Rule 301.

    d. Rule 302.

30. In an engagement letter to a client for a consultation for obtaining financing, what should ***not*** be included?

    a. An estimated date of completion of the consultation.

    b. The scope of services to be provided to the client in the consultation.

    c. A guarantee that financing will be obtained.

    d. Permission for the consultant to disclose confidential information to lenders.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

27. When the borrower is negotiating financing, he or she should seriously consider the individuals required to guarantee the loan and the nature of the guarantees. There are various forms of guarantees. With which of the following forms of guarantees is the guarantor liable for less than the full amount of the loan? **(Page 287)**

    a. Unlimited guarantee. [This answer is incorrect. With an unlimited guarantee, the guarantor is personally liable for the entire amount of the loan.]

    b. Joint and several guarantee. [This answer is incorrect. Two or more individuals are each responsible for the entire amount of the loan with a joint and several guarantee.]

    c. Limited or proportionate guarantee. [This answer is correct. The guarantor is liable for less than the full amount of the loan with a limited or proportionate guarantee.]

    d. Time guarantee. [This answer is incorrect. With a time guarantee, the guarantee can be reduced or removed after certain conditions are met, such as after a specified time period has expired or after the company has met certain performance targets.]

28. Which of the following actions should the CPA avoid when participating with the client in negotiating the financing? **(Page 287)**

    a. Assume the role of agent for the client. [This answer is correct. The consultant should avoid assuming the role of management or agent for the client.]

    b. Explain financial information in the proposal. [This answer is incorrect. The consultant might be asked by the client to be present at the negotiations to explain financial information in the proposal.]

    c. Assist in demonstrating different repayment plans. [This answer is incorrect. The client might ask the consultant to provide assistance in demonstrating different repayment plans.]

    d. Advise client regarding matters that arise during negotiations. [This answer is incorrect. The consultant can advise the client about matters that might come up during the negotiations, but only the client should make decisions or commitments to the lender.]

29. Disclosure of confidential information except with the consent of the client is prohibited by _____ of the *Code of Professional Conduct*. **(Page 286)**

    a. Rule 101. [This answer is incorrect. Rule 101 of the *Code of Professional Conduct* addresses the area of independence.]

    b. Rule 201. [This answer is incorrect. Rule 201 of the *Code of Professional Conduct* deals with general standards.]

    c. Rule 301. [This answer is correct. Rule 301 of the *Code of Professional Conduct* pertains to confidential client information and states that a member in public practice shall not disclose any confidential client information without the specific consent of the client.]

    d. Rule 302. [This answer is incorrect. The *Code of Professional Conduct*, Rule 302, covers contingent fees.]

30. In an engagement letter to a client for a consultation for obtaining financing, what should ***not*** be included? **(Page 287)**

a. An estimated date of completion of the consultation. [This answer is incorrect. A clear understanding of when the engagement will be completed should be included in the engagement letter and communicated to the client.]

b. The scope of services to be provided to the client in the consultation. [This answer is incorrect. Since obtaining financing has several phases, the client and consultant should agree to the scope of the consultation in the engagement letter.]

c. A guarantee that financing will be obtained. [This answer is correct. The engagement letter should iterate, and the consultant should make sure that the client understands, that the consultant cannot guarantee that financing will be obtained.]

d. Permission for the consultant to disclose confidential information to lenders. [This answer is incorrect. If the engagement required the consultant to participate in negotiations with potential lenders, then the client should give the consultant permission to disclose confidential information during the negotiations.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (CONTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

13. Which of the following types of financing would be best suited to a contractor that intends to buy materials early to protect itself from price increases?

    a. An increase to its line of credit.

    b. Long-term financing.

    c. Financing for the additional holding period.

    d. Repackage existing property with new property as collateral for a loan.

14. Hidden Creeks Shirt Manufacturers wants to acquire a competitor in the clothing manufacturing business. What financing term is most appropriate for this business acquisition?

    a. Long-term.

    b. Medium-term.

    c. Short-term.

    d. Either medium-term or short-term.

15. When considering private sources of financing, many sources may be considered. Which of the following would **not** be considered a *personal source* of private financing?

    a. Selling investments.

    b. Liquidation of savings accounts.

    c. Credit card advances.

    d. Funds obtained from a friend.

16. One source of financing that a client may seek is financing by private sources, such as the client's customers. Under this approach a contract may be negotiated that allows for a reduced retention during performance of the work, and full retention payment for individual work items _____ after that particular item is complete.

    a. 30 days.

    b. 60 days.

    c. 90 days.

    d. 120 days.

17. Line-of-credit commitments must be reapproved each time they expire. In addition, many banks require the borrower to repay the line of credit and not draw down any other loans from the bank for a period of time, generally:

    a. 30 to 60 days.

    b. 60 to 90 days.

    c. 60 to 120 days.

    d. 90 to 120 days.

18. Short-term financing through commercial paper would be least likely to be used for which of the following companies?

    a. Bill's Tailored Clothing Company.

    b. J & J Plumbing Supplies.

    c. McCaslin Construction Company.

    d. Anna's Stationery and Card Stores.

19. Medium-term financing includes all of the following **except**:

    a. Mortgage loans.

    b. Term loans.

    c. Leasing arrangements.

    d. Government loan programs.

20. Jenna's Dress Shop was destroyed by a tornado and the owner has applied for a SBA guaranteed loan to finance the purchase of a complete inventory of dresses to reopen the business. Under SBA guidelines for this type of loan, the owner will have to complete payment of this loan within approximately:

    a. 3 years.

    b. 10 years.

    c. 20 years.

    d. 25 years.

21. Of the following companies, which one has the least likelihood of obtaining long-term financing?

    a. Thick Cut Steakhouse Corporation.

    b. Cady's Department Stores, Inc.

    c. Smith Construction Contractors.

    d. Harold's Furniture Company.

22. Which of the following companies qualifies to receive capital from a Small Business Investment Company (SBIC) that is licensed and regulated by the Small Business Administration (SBA)?

    a. A plumbing supply company with a tangible net worth of $20 million and average net income after federal income taxes (excluding carryover losses) of $8 million for the last two fiscal years.

    b. A restaurant chain with a tangible net worth of $16 million and average net income after federal income taxes (excluding carryover losses) of $8 million for the last two fiscal years.

    c. A public relations firm with a tangible net worth of $18 million and average net income after federal income taxes (excluding carryover losses) of $5 million for the last two fiscal years.

    d. A lawn sprinkler company with a tangible net worth of $12 million and average net income after federal income taxes (excluding carryover losses) of $7 million for the previous fiscal year.

23. One form of long-term financing is the direct placement loan. Direct placement loans are usually obtained from institutional investors such as pension funds and life insurance companies. The loan period is typically from _____, and the interest rate may be fixed or variable.

    a. 5 to 10 years.

    b. 5 to 15 years.

    c. 10 to 15 years.

    d. 10 to 20 years.

24. Once a client has decided on a financing plan to pursue, a financing proposal should be submitted to potential funding sources. The information provided in the financing proposal should be designed to assist a potential lender in determining whether the loan principal and interest will be paid when due. According to lending institutions, which of the following factors would be the most important in assessing whether the loan principal and interest will be paid on time?

    a. Quality of management.

    b. Risk of default.

    c. Intended purpose of loan.

    d. Firm's liquidity position.

25. When requesting historical financial statements, lenders may request interim statements if the latest annual statements are more than:

    a. One year old.

    b. 270 days old.

    c. 240 days old.

    d. Three to six months old.

26. Generally, the lender requests prospective information for at least the first year after the financing is received and may request prospective information for _____.

    a. The first year and a half after the financing is received.

    b. The first two years after the financing is received.

    c. The first two and a half years after the financing is received.

    d. The entire period of the loan.

27. Of late, lenders have been imposing more restrictive terms and conditions when negotiating the financing. The client should be aware of the various types of terms and conditions that lenders might impose and determine several positions for each potential negotiating point. Which of the following is **not** one of the positions the client needs to determine for each potential negotiating point?

    a. Ideal position.

    b. Preferred position.

    c. Acceptable position.

    d. Unacceptable position.

28. The _____ is the type of loan guarantee that can be reduced or removed after the company has met certain performance targets.

    a. Unlimited guarantee.

    b. Joint and several guarantee.

    c. Limited or proportionate guarantee.

    d. Time guarantee.

29. Creative ways of negotiating with a new potential lender may include a number of actions. Which of the following would **not** enhance the negotiating position with a new potential lender?

    a. Identify other financing to add subordinate capital to any new senior bank loans proposed.

    b. Taking the firm private in the future to preclude outside influence on cash flows that would affect repayment.

    c. Develop alternative secondary repayment sources in lieu of sufficient capital.

    d. Selling the company to create cash flows to repay the bank.

30. Which of the following statements is accurate regarding a representation letter used in a financing services engagement?

    a. A representation letter serves to consolidate any written representations the client makes to the consultant during the engagement.

    b. A representation letter should be obtained even if the engagement is limited to analyzing financing needs and sources.

    c. Generally a representation letter should be obtained whenever the consultant prepares all or some of the financing proposal.

    d. It is suggested, although not required, that a CPA obtain signed representations when compiling a financial projection or reviewing or auditing historical financial statements.

Lesson 3: Consulting—Claim Settlement Services

INTRODUCTION

Construction claims have been around as long as construction projects. Since most construction efforts are unique, one-time projects that include numerous uncertainties, construction projects are seldom completed as planned and within the contractor's and owner's original budgets. The mere nature of the business is one of ongoing change. Changes in construction projects result from:

a. The inability to proceed with the project as planned (such as, inability to obtain a right-of-way for access to build or inability to construct the project as designed by the architect and engineers).

b. The project owner changing his mind about what he wants.

c. Changes in the construction effort sequence.

d. Improper installation or materials.

e. Obtaining incorrect specifications in the initial design plans.

f. Untimely responses for requests for information (RFIs).

g. Weather delays.

Almost all changes result in increased costs. Many of the changes in the construction industry occur in the normal course of business under terms of a pre-agreement, such as a *change order*, that spells out who (the contractor or the owner) will incur the increased costs. In some instances a compromise is reached at the completion of the contract without the need for a settlement process.

In other situations, however, the contractor and the owner are unable to reach an agreement and require outside help in ultimately reaching an agreement. The contractor and/or the owner may look to a CPA to provide help in reaching an agreement. A CPA can assist a contractor in settling a construction claim in a variety of ways. He can help identify the reasons for a dispute or events and conditions that might give rise to damages. He can also help the contractor quantify the costs associated with a particular event or condition.

A CPA engaged to assist in resolving a claim should be aware of the various methods that are available to settle the claim. Litigation is a method that is widely used. If a claim is being litigated, the CPA should be familiar with the litigation process, including the *art* of testifying and the administrative considerations in supporting a litigation claim.

Besides litigation, other methods of claim settlement are becoming increasingly popular. Those methods are referred to as alternative dispute resolution methods and include such procedures as mediation and arbitration. Beyond litigation and alternative dispute resolution methods, less formal efforts occur in construction disputes as well. A contractor may simply request help costing out a change order or confirming information that he plans to use in informal discussions with an owner. Many of the services that a CPA might provide in formal methods of claim resolution (such as, identifying and quantifying items of dispute) are also applicable to alternative dispute resolution methods and to even less formal applications.

The following topics are discussed in this lesson:

a. Ways to resolve contractor claims.

b. Identifying events or conditions that may result in damages.

c. Calculating contractor damages.

d. Engagement activities and administration.

In addition to the services mentioned above, a CPA might assist a contractor presenting its case in court by acting in an "expert" capacity.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize ways to resolve contractor claims and identify events or conditions that may result in damages.
- Calculate contractor damages.
- Identify engagement activities and administration.

Ways to Resolve Contractor Claims

The primary methods of resolving claims relating to construction contracts are:

a. Mediation.

b. Arbitration.

c. Combined mediation/arbitration.

d. Neutral evaluation.

e. Litigation.

Mediation and arbitration are often described as alternative dispute resolution (ADR) methods. ADR is an increasingly popular way of attempting to resolve disputes, including construction claims, without exposing a contractor to the time, cost, and uncertainty of litigation.

ADR often provides a better chance of preserving relationships. Unfortunately, the parties to non-binding methods of dispute resolution sometimes have no intention of modifying their position. Thus, the CPA must work closely with the client's legal counsel to determine whether the steps before trial are worthwhile. The CPA does not want to divulge important parts of the case when the other side is searching for information or delay going to court if the other side has no intention of settling. State and federal agencies tend to settle in dispute resolution settings at equitable values when they acknowledge the contractor's right to additional compensation. However, more and more local governments, school districts, and local agencies tend to want a court decision requiring them to pay the contractor any additional amounts, or at least delay payment settlement to the courthouse steps.

Mediation. One well-known ADR technique is mediation. Under this technique, a mediator hears arguments from both sides and attempts to facilitate an agreement between the two parties. Mediation is nonbinding because there is no solution until both sides agree. Contractors might include a mediation clause, such as the following, in their construction contracts.

> The owner and contractor agree that disputes arising from the meaning, performance, or enforcement of this contract will be submitted, upon written request of one of the parties, to a mediator. The mediator will be selected from a listing of mediation providers approved by (insert agreed-upon approval entity). The mediation proceedings will be conducted in accordance with the Construction Industry Mediation Rules established by the American Arbitration Association. Other rules may be used if agreed to by both parties. The results of the mediation will not be binding unless both parties agree and the costs of any proceedings will be shared equally.

Contractors should, however, consult with their attorney before including such a clause in a contract.

The American Institute of Architects' A201 contract requires mediation as a "condition precedent" to arbitration. Thus, before a case may be submitted to arbitration, it must be mediated. The "Construction Industry Arbitration Rules and Mediation Procedures" adopted by the American Arbitration Association (AAA) include specific rules to govern mediation proceedings. These rules may be accessed at the AAA's website at **www.adr.org/arb_med**.

Arbitration. One of the best known ADR techniques is arbitration. Under an arbitration agreement, both parties engage a neutral third party or a panel of arbitrators who understand construction contracts to hear arguments, consider evidence, and make a decision. Like mediation, arbitration may be voluntary or mandated by contract, and the arbitrator's decision may be binding or nonbinding. For the decision to be binding, the parties must agree to accept the arbitrator's decision before the arbitration starts.

The American Arbitration Association's (AAA) "Construction Industry Arbitration Rules and Mediation Procedures" govern arbitration cases in the construction industry. These rules provide three possible "tracks" for an arbitration process to follow. The tracks are determined based on the size of a dispute, as follows:

a. The "fast track" is for claims of no more than $75,000. However, both parties and the arbitrator may agree to use "fast track" procedures for claims in excess of $75,000.

b. The "regular track" is for claims of $75,000 to $500,000.

c. The "large, complex case track" is for claims of at least $500,000.

The rules grant the arbitrator power to control the hearings and require the arbitrator to provide a written breakdown of the award, including any computations necessary for recalculating the award. The rules may be downloaded from the AAA's website at **www.adr.org/arb_med**.

Fast Track Procedures. Initially, the AAA reported that approximately 50% of its construction arbitration cases involved claims of $75,000 or less. To reduce the time and expense necessary to settle this size of case, the AAA created the fast track procedures. Some of the key features of the fast track include the following:

a. One arbitrator is selected or appointed to hear the case, although the parties are encouraged to agree to an arbitrator from the list of "Fast Track" arbitrators provided by the AAA.

b. If total claims are less than $10,000, an arbitrator may decide the case without a hearing.

c. If a hearing is to be held, it must take place within 30 days of the appointment of an arbitrator and generally shall not exceed one day. Both parties and the arbitrator should participate in a conference call before the hearing to discuss the case.

d. Discovery is generally not allowed, except for the parties exchanging exhibits at least two days before the hearing.

e. The arbitrator will render the award no later than 14 days after the conclusion of the hearing.

Regular Track Procedures. Many of the procedures used in fast track cases may also be used in regular track cases. The following are the key differences between fast track and regular track procedures:

a. One arbitrator is usually appointed or selected, unless the arbitration agreement specifies differently or if the AAA determines that more arbitrators are needed.

b. Discovery is generally not allowed except for the parties exchanging exhibits at least five days before the hearing.

c. A preliminary hearing may be held if requested by either party or the AAA. The purpose of the hearing is to agree upon the issues to be resolved, to schedule the arbitration hearing, and to address any other areas that might facilitate the arbitration process.

d. The arbitrator will render the award no later than 30 days after the conclusion of the hearing.

Large, Complex Case Track Procedures. The key features of the large, complex case track procedures include the following:

a. One to three arbitrators are usually selected; however, the parties may agree to use only one arbitrator.

b. Before the selection of arbitrators, an administrative conference is held between both parties and the AAA to discuss the desired qualifications of the arbitrators, obtain further information about the dispute, and to estimate the length and timing of the hearing. However, the AAA may determine that this administrative conference is not necessary.

c. A preliminary hearing is held after the selection of the arbitrators to discuss the details of the hearing, including the identification and availability of witnesses and expert witnesses, the extent of discovery, and the schedule of the hearings.

d. Arbitrators shall take the steps they consider necessary or desirable to avoid delay and achieve a just, speedy, and cost-effective resolution of the case.

Arbitration Characteristics of Particular Interest to an Expert. An expert engaged as a witness or consultant for an arbitration should be aware that once a dispute enters binding arbitration, the matter is unlikely to settle, and a full arbitration hearing will likely take place as scheduled. Because the arbitration is a private proceeding, the risk of negative publicity often associated with litigation is eliminated. Also, arbitrators tend to seek a *middle-of-the-road* resolution, and the awards tend not to be as extreme as the damages that might be awarded in litigation. Thus, many of the factors that create pressure to settle in litigation are absent in an arbitration. As a result, expert engagements should be scheduled and allocated resources based on the expectation that a full-scale arbitration hearing will be held.

The expert should also be aware that the time and resources required for arbitration are usually the same as for a trial. Although the damages awarded to the winner might not be as large as those in a trial, the stakes can still be very high, and neither party can afford to approach the hearing without the same thorough preparations required for a trial.

During testimony preparation, the expert should attempt to understand as much as possible about the background, knowledge, and experience of each of the arbitrators. Obtaining a favorable decision is dependent on persuading a majority of the arbitrators. Therefore, the presentation must often be more focused to the individual traits of the arbitrators than is common in litigation decided by a judge or jury.

It is particularly important for the expert to understand the arrangement between the individual arbitrators and the disputing parties. The tone of the hearing will be different, depending on whether all arbitrators are selected as neutral parties, or whether there is a neutral chairman with the other arbitrators selected by each side. When each party chooses an arbitrator as its representative, the expert should expect much more aggressive and knowledgeable questioning from the opposing party's arbitrator.

The expert must keep the background, knowledge, and experience of each of the arbitrators in mind when answering questions. The arbitrators who are experts in the subject matter might ask very complex technical questions. In answering these questions, the expert witness has to give a complete and accurate technical answer, but also has to answer in a manner that is informative to the neutral chairman who may not be as technically knowledgeable. This might require an explicit and brief answer to the question to satisfy the more knowledgeable arbitrator with an expanded explanation in more simple language for another arbitrator.

Combined Mediation/Arbitration. Combined mediation/arbitration is a two stage process during which the parties agree to attempt to settle the dispute through nonbinding mediation and, if that fails, to submit the matter to binding arbitration. The belief is that the threat of moving to binding arbitration will put pressure on the parties to settle disputes through mediation.

Neutral Evaluation. Neutral evaluation is often used when the parties have previously arrived at widely differing conclusions concerning a particular issue. For example, if the parties' claim calculations vary greatly, a neutral evaluator may be brought in to resolve the difference. Alternatively, one evaluator may be chosen at the outset, to which the parties agree they will be bound.

Other ADR Techniques. While arbitration and mediation are the best known ADR techniques, others are also available. Two other common ADR procedures are the minitrial and the summary jury trial. The minitrial is a one- to two-day meeting in which the senior executives of the businesses involved in the dispute and their attorneys meet

informally with a neutral third party, such as a retired judge or a lay person experienced in the subject matter. After hearing arguments from both sides, the neutral third party gives a nonbinding, confidential advisory opinion to the parties. Using the advisory opinion, the parties then attempt to negotiate a settlement.

In a summary jury trial, the attorneys make brief oral arguments in front of a judge and jury. The jury's "verdict" is nonbinding and may be used as a starting point for settlement negotiations between the parties. In some cases the judge will permit live testimony, usually limited to one witness per side.

The goal of these two types of proceedings is to minimize trial length and avoid the time consumed with multiple witnesses. Therefore, the attorney will present the substance of the testimony that would have been presented by an expert in a normal trial. When resolving disputes involving government contracts, a client may need to deal with the Board of Contract Appeals (BCA) or one of the government's Dispute Resolution Boards (DRBs).

Applicability of Remaining Guidance to Methods of Resolving Claims

Generally, the guidance included in the remainder of this section can be used to support settlement of construction claims regardless of the method selected to resolve the claim (alternative dispute resolution or litigation). For example, identifying the areas of dispute and calculating contractor damages would need to be done in almost all claims.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Nelson Construction Company has filed a claim for payment connected with additional work that was accomplished on a construction site for which Nelson believes additional payment is due. The claim will be heard and evidence submitted will be considered in an arbitration both parties have agreed to. Nelson's claim is for $100,000. According to the American Arbitration Association's (AAA) "Construction Industry Arbitration Rules and Mediation Procedures", generally which of the following "tracks" should the arbitration process follow?

    a. "Lightning track."

    b. "Fast track."

    c. "Regular track."

    d. "Large, complex case track."

32. Which of the following is a feature of the "fast track" arbitration process?

    a. One to three arbitrators are usually selected.

    b. If total claims are less than $20,000, an arbitrator may decide the case without a hearing.

    c. If a hearing is to be held, it must take place within 15 days of appointment of an arbitrator.

    d. Discovery is generally not allowed.

33. Of the following, which feature applies to the "large, complex case track" arbitrations process?

    a. Three arbitrators are always required.

    b. An administrative conference is always required.

    c. A preliminary hearing is held after selection of the arbitrators.

    d. The arbitrators will render the award no later than 45 days after the conclusion of the hearing.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Nelson Construction Company has filed a claim for payment connected with additional work that was accomplished on a construction site for which Nelson believes additional payment is due. The claim will be heard and evidence submitted will be considered in an arbitration both parties have agreed to. Nelson's claim is for $100,000. According to the American Arbitration Association's (AAA) "Construction Industry Arbitration Rules and Mediation Procedures," generally which of the following "tracks" should the arbitration process follow? **(Page 299)**

    a. "Lightning track." [This answer is incorrect. The AAA's "Construction Industry Arbitration Rules and Mediation Procedures" provide three possible tracks to follow based on the size of a dispute. The "lightning track" arbitration process is not one of those three tracks.]

    b. "Fast track." [This answer is incorrect. The "fast track" is normally for claims of no more than $75,000. Nelson's claim is for $100,000.]

    c. "Regular track." [This answer is correct. The "regular track" is for claims of $75,000 to $500,000. Therefore, Nelson Construction Company's claim of $100,000 would qualify for "regular track" processing of the claim.]

    d. "Large, complex case track." [This answer is incorrect. The "large, complex case track" is for claims of at least $500,000. Nelson's claim is only $100,000.]

32. Which of the following is a feature of the "fast track" arbitration process? **(Page 299)**

    a. One to three arbitrators are usually selected. [This answer is incorrect. One feature of the "fast track" arbitration process is that *one* arbitrator is selected or appointed to hear the case. However, the parties are encouraged to agree to an arbitrator from the list of "fast track" arbitrators provide by the AAA.]

    b. If total claims are less than $20,000, an arbitrator may decide the case without a hearing. [This answer is incorrect. In the case of the "fast track" arbitration claims process, an arbitrator may decide the case without a hearing if total claims are less than *$10,000*.]

    c. If a hearing is to be held, it must take place within 15 days of appointment of an arbitrator. [This answer is incorrect. If a hearing is to be held in a "fast track" arbitration process, it must take place within *30* days of the appointment of an arbitrator and generally shall not exceed one day in length.]

    d. Discovery is generally not allowed. [This answer is correct. Under the "fast track" procedures, discovery is generally not allowed, except for the parties exchanging exhibits at least two days before the hearing.]

33. Of the following, which feature applies to the "large, complex case track" arbitrations process? **(Page 299)**

    a. Three arbitrators are always required. [This answer is incorrect. One to three arbitrators are usually selected, but the parties may agree to use only one arbitrator.]

    b. An administrative conference is always required. [This answer is incorrect. An administrative conference is generally held; however, the AAA may determine that this administrative conference is not necessary.]

    c. A preliminary hearing is held after selection of the arbitrators. [This answer is correct. A preliminary hearing is held after the selection of the arbitrators to discuss the details of the hearing, including the identification and availability of witnesses and expert witnesses, the extent of discovery, and the schedule of the hearings.]

    d. The arbitrators will render the award no later than 45 days after the conclusion of the hearing. [This answer is incorrect. Arbitrators shall take the necessary or desirable steps to avoid delay and achieve a just, speedy, and cost-effective resolution of the case. There is no requirement that the arbitrators render the award within 45 days after conclusion of the hearing.]

Identifying Events or Conditions That May Result in Damages

One of the first challenges in helping settle a dispute is identifying the actual areas of disagreement or dispute. Until the areas of dispute are identified, it is impossible to determine whether the contract has been breached. In addition, quantifying any damages must follow the identification of the actual areas of disagreement. It is generally believed that, using project accounting and project controls software can provide the necessary data and save contractors money and avoid frustration. Such software tracks costs against bid details, allowing the contractor to identify more precisely where the budget overruns exist and strengthen its case for additional compensation. Unfortunately, many contractors do not utilize this tool, which results in the need to identify and document cost overruns manually after a project is completed.

Disputes arise for a variety of reasons including contract scope, timing of the contract effort, and almost anything else that impacts contract performance or cost. Generally, areas of dispute are grouped into the following five broad categories:

a. Delays.

b. Disruption.

c. Changes in scope.

d. Changed conditions.

e. Termination.

Delays. A delay occurs when the contractor has not completed the agreed-upon effort within a predetermined schedule of completion. Delays are perhaps the most common reason for construction contract disputes. They can be caused by numerous problems such as late architectural drawings, lack of decisions or approvals, defective materials, and lack of right-of-way. In addition, delays can be caused by such things as weather or labor disputes.

Delays almost always increase the total cost of the construction project by increasing time-related efforts such as contract management, equipment, and facilities. In other words, the longer a project takes to complete, the more time contract management personnel must supervise the project (probably taking them away from other projects). In addition, it may be impractical to move equipment and facilities (such as an on-site office facility) physically located at the job site before the contract is complete. That prohibits those resources from being used on other contracts.

Significant delays can also cause increases in cost through inflation and can affect labor productivity. In other words, if contract completion gets pushed to future periods, it may cost the contractor more as a result of increasing prices. For example, many contractors use union labor subject to pre-determined points of pay raises. A contractor may have planned to finish the contract at a lower rate-per-hour than is actually realized. Labor productivity can also be affected by delays, particularly if employees are concerned about getting laid-off during slow times while awaiting decisions to be made. Costs also can be increased by an acceleration of work following a delay.

Disruption. Disruption is the term used when a contractor is not able to perform the work in the manner planned. For example, a contractor may be forced to stop work frequently due to numerous change orders or to wait for other contractors to finish their efforts. The project owner can also cause disruption by not making timely decisions or by interfering with the work effort.

The principal basis for a disruption claim is that the contractor realized lower productivity as a result of the disruption(s), which led to an increase in the contractor's labor costs. The contractor might also have additional overhead costs for project management and/or time delays related to the disruption.

Changes in Scope. Changes are a routine part of completing a construction project. It would be very unusual for a project to be completed with no changes from the original plan. Even though changes may be unexpected or unintentional, they may still severely impact the cost and timing of a particular construction project when they are excessive. Often, an individual change may be relatively insignificant to the contract as a whole. However, the accumulation of several individual changes may increase the project cost quite dramatically.

In addition to an excessive number of change orders, a change in scope can also occur as a result of erroneous bid specifications. In that case, a request for bid might not give exact specifications to be used in completing the project. As a result, the contractor assumes one thing for purposes of submitting a bid and is required to use another in actually completing the project. For example, the type of steel specified for the frame of a bridge may turn out to be inappropriate for the design characteristics. That situation often occurs on unique projects where the designers may not be initially certain what material or method is most appropriate.

Changed Conditions. Claims may also result from increases in cost caused by changes in conditions. Claims in this area generally occur when information furnished to the contractor at bid-time differs from the conditions the contractor actually encounters in completing the project. For example, if the contractor encounters a clay base upon which to build a foundation and he based his bid price on bedrock, the situation would be considered a changed condition. Another example is where a contractor received the incorrect specifications for a project at the time the bid was made.

Termination. Termination of a project can occur for many reasons. One reason is the item may no longer be needed. Other reasons might be that the project is obsolete, adequate funding could not be obtained, or there are environmental problems surrounding the project.

In addition to rational reasons for termination, an owner may terminate a contract for unreasonable, unfair, or false reasons alleged by the owner. Usually when wrongful termination can be proven, the contractor is able to recover an amount that compensates for the amount of profit lost on the terminated job.

Summary of Events or Conditions That May Cause Claims. Exhibit 1-1 provides a basic list of events or conditions that can result in a claim. Along with the event or condition is the general category used in the construction industry to describe the type of claim event.

Exhibit 1-1

Events or Conditions That May Cause Claims

	Type of Claim Caused				
Event	**Delay**	**Disruption**	**Changes in Scope**	**Changed Conditions**	**Termination**
Differing site conditions	✓			✓	
Incorrect specifications	✓	✓	✓	✓	
Excessive change orders			✓		
Late drawings	✓	✓			
Changes in sequence	✓	✓			
Lack of decisions or approvals	✓	✓			
Lack of access	✓	✓			
Lack of right-of-way	✓	✓		✓	
Interference	✓	✓			
Errors in management	✓	✓			
Suspensions	✓	✓			✓
Impossibility			✓	✓	✓
Weather	✓	✓		✓	
Lack of funds					✓
Labor strikes	✓	✓			✓
Bankruptcy					✓

* * *

Many of the dispute categories discussed above result in lost productivity for the contractor. Specifically, lost productivity may occur from any disruption that was not reasonably anticipated when the project was planned and bid.

Other Considerations in Identifying Events or Conditions That May Result in Damages. An important first step in identifying events or conditions that may result in damages is to understand what the contractor is entitled to under terms of the contract. That understanding is accomplished by a thorough reading of the contract. In many cases, the contractor may not even be sure what is included in the contract. Becoming familiar with the terms of the contract is key to helping the contractor identify events or conditions that are outside the scope of the original contract and that may result in damages.

In some instances, a contractor may not be fully aware of what specific events or conditions caused a project to go over budget. However, the contractor knows the project is over budget and believes the project owner is at least partially responsible for the overage. Such instances are common when there are numerous individually insignificant events that affected completion of the project. As a result, the contractor may ask the CPA to help identify events or conditions that might result in additional billings (damages). A good way to begin this effort is to compare the actual results of the project on a line-by-line basis with what was estimated at bid-time. For example, compare actual material costs with those estimated and compare actual direct labor with the initial estimate. The comparison should highlight those areas where actual results differ significantly from the initial bid estimates. Usually, those are the primary areas where claims or additional billings can result.

After the primary areas of additional costs are identified, the CPA can gain additional knowledge of the reasons for overruns by:

a. Reviewing detail field logs that note problems that occurred while completing the project.

b. Interviewing key supervisory personnel responsible for the project.

c. Comparing details of the cost build-up to the details used in putting together the bid estimate.

Is a Contract Audit Necessary? A contract audit is an investigation by the CPA of the contract costs, revenues, and resulting cost overrun. This is a key aspect in preparing the CPA for supporting the contractor's claim, particularly if the CPA is going to give testimony during a trial. A contract audit can:

a. Help identify any embarrassing costs and contractor mistakes that may overstate the claim or indicate a failure to mitigate damages.

b. Provide the CPA with knowledge and an understanding of the contractor's cost system, history of the contract, and related disputes so that he or she can provide valuable advice to any involved attorneys. (That understanding is invaluable when a CPA is providing expert witness testimony.)

c. Help develop approaches for presenting the contractor's case.

d. Develop a database for direct labor, material, equipment, and overhead costs. (Such a database is important in pricing damages and allows for last-minute changes in approaches to presenting or quantifying damages.)

e. Provide a cost-effective method of obtaining information. (A contract audit usually more than pays for itself through the benefits cited above.)

A contract audit is useful for identifying problem areas and proving damages under either the discrete or total cost approach. Examples of how a contract audit can be used in quantifying contractor damages include:

a. Reconciling the labor rates used to cost a disruption claim to the actual rates per the payroll journal for that specific time period.

b. Reconciling time related costs (that is, those increases in cost resulting from the extension of the time of a contract) to the contract audit. (Time related costs include such costs as job management salaries, job site office, guards, accountants, timekeepers, and clerks.)

c. Comparing actual to planned material costs to identify overruns or to substantiate actual quantities and engineering calculations.

Calculating Contractor Damages

After the events or conditions that may have resulted in damages are identified the next step is to quantify the dollar amount of the damages relating to those conditions. There are several methodologies for calculating contractor

damages. Regardless of the method used, it is important to remember the following general requirements when completing this step:

a. The costs reimbursed in other claims or change orders, especially downtime/delay costs such as overhead, should be considered.

b. The damages (for claimed additional cost) should be *reasonable* in light of the specific facts of the situation. For example, if a contractor used a fully depreciated, old piece of equipment in completing the contract, he should not use the rental rate of a new piece of equipment to price out any excess equipment time claimed as damages.

c. The damages should be *carefully defined*. In other words, how the damages were calculated should be simply stated and supported by understandable documentation, and where appropriate, referenced to the contract provisions supporting the calculation.

d. The damages must be *calculated on the basis of the events and conditions causing the claim*. For example, if a contractor claims that a project was delayed because of late drawings, the cost impact should clearly and concisely support how the contractor calculated the increased cost resulting from only the late drawings.

e. The damages generally must be calculated based on the agreed-upon pricing, if included in the contract. For example, some construction contracts include a forward pricing mechanism that sets the amount to be paid for certain additional work, changed conditions, delays, or other problems encountered during the performance of the contract.

There are generally four approaches to calculating contractor damages: (a) the total cost approach, (b) the modified total cost approach, (c) the estimated cost approach, and, (d) the discrete approach. These approaches are discussed below.

Total Cost Approach. The total cost approach is often used by contractors when they need to calculate damages quickly. Basically, the contractor determines the actual cost of completing a construction project. The contractor then claims as damages the total of such costs plus a reasonable profit and overhead, reduced by whatever has already been paid by the owner. Exhibit 1-2 presents a typical claim summary using the total cost approach.

Exhibit 1-2

Typical Claim Summary Total Cost Approach

Incurred contract costs:	
Direct labor	$ 200,000
Direct materials	75,000
Subcontract cost	525,000
Equipment	125,000
Miscellaneous other	60,000
	985,000
Indirect costs	100,000
Total costs	1,085,000
Total revenue (per contract, adjusted for change orders)	975,000
Cost overrun	110,000
Increased by:	
Home office general and administrative costs (8% of total cost)	86,800
Profit (10% of total cost increased by home office general and administrative costs)	117,180
Cost of capital	25,000
Total claim	338,980
Preparation costs of claim	22,000
Interest from notice date through (date of claim)	15,000
Total due at (date of claim)	$ 375,980

* * *

The total cost approach generally disregards individual reasons for delay. In other words, the contractor does not list the reasons for the increased costs, try to prove that he or she was not responsible for those increased costs, and assign a specific cost to each individual reason. The premise behind this approach is that the total cost overrun is the result of another party's acts (such as the project owners) and is not related to the contractor's own inefficiencies or mismanagement.

Many jurisdictions do not allow use of the total cost approach. In addition, it is unlikely that this approach will be allowed by parties involved in a government contract. The approach may be allowed, however, in situations where the contractor can show that no other approach is feasible.

When the total cost approach is used, the claim should generally provide evidence that—

a. Total costs claimed to have been incurred on the contract are correct. (For example, the contractor must be able to show that the costs recorded are in accordance with generally accepted accounting principles and are in accordance with the contract requirements.)

b. The contract price was reasonable and the submitted bid was properly prepared.

c. The total contract overrun is the result of the other party's actions.

d. The overrun costs are not related to the contractor's own inefficiencies or mismanagement.

e. The nature of the situation is such that it is impossible or impractical to use any other approach in costing the claim.

The total cost approach is not the predominant form of pricing damages because it essentially requires the contractor to be fault free, which is rarely the case. Usually a contractor's inability to keep adequate records or books is not an appropriate reason to use the total cost approach.

Modified Total Cost Approach. The modified total cost approach corrects some of the problems with the total cost approach. The total cost approach basically requires the contractor to be fault free. The modified total cost

approach is generally the same as the total cost approach except that it allows the contractor to deduct amounts when the contractor or other parties are partially responsible. Like the total cost approach, the modified total cost approach is not the predominant form of pricing damages.

Estimated Cost Approach. As the name implies, the estimated cost approach is used to estimate damages when actual costs are incomplete or unreliable. (For example, subcontractor amounts might be incomplete.) The contractor uses assumptions when actual amounts are not available to calculate damages and provides documentation to support those estimates and may include expert witnesses. Estimates are compared to other projects the contractor has completed with similar costs.

Discrete Approach. The discrete approach, also known as the actual cost approach, is the predominant method for pricing damages. It basically consists of—

a. Identifying each specific matter or event that caused an increase in cost, and

b. Defining the related costs incurred as a result of the specific matter or event.

Exhibit 1-3 presents a typical claim summary using the discrete approach.

Exhibit 1-3

Typical Claim Summary Discrete Approach

Delay	
Extended field support due to lack of right-of-way (8 weeks at $13,000 per week)	$ 104,000
Increased material costs due to delay	8,000
Disruption—Decreased labor productivity due to lack of right-of-way (8%)	67,000
Unpaid Change Orders	
Premium on overtime due to acceleration of schedule to meet original schedule	6,000
Expanded parking lot space	8,000
Cost of capital resulting from negative cash flow due to delay, disruption, and unpaid change orders	4,000
	197,000
Increased by	
Home office general and administrative costs (8% of total cost without cost of capital)	15,440
Profit (10% of total cost without cost of capital)	20,844
Total claim	233,284
Interest from notice date through (date of claim)	15,000
Total due at (date of claim)	$ 248,284

* * *

The discrete approach is more complex than the total cost approach. The starting point for the discrete approach is preparation of a series of schedules that show the final results of the completed contract under dispute. Such schedules provide a source for identifying where the primary overruns occurred, the reasons for those overruns, and whether the overruns were caused by the owner. Additionally, reviewing the final actual results of the completed contract provides attorneys working on the claim, if any, with an understanding of what will be required to make the contractor "whole," including a fair profit.

The final results of the contract should also be examined for underruns to ensure that overruns are not directly related to an underrun. For example, a contractor might perform certain work rather than subcontracting it. In addition, the results should be examined for expected relationships that exist between certain costs. For example, a significant overrun in labor for a delay claim would not normally result in a corresponding overrun of materials and might be the result of an inadequate estimate.

The following paragraphs discuss how to calculate damages and capture and document costs for the following types of contractor cost:

a. Labor and labor related benefits/burdens.

b. Equipment use costs.

c. Home office overhead.

d. Other contract costs.

Labor and Labor-related Benefits/Burdens. The most significant aspects of many construction claims are labor costs and the related benefits/burdens. Additional labor costs can be a result of labor hours in excess of the number planned or increased labor rates and related employment costs.

Calculating Excess Labor Hours. Calculating a loss of productivity that results in excess labor hours on a project can be straightforward or may be very difficult. The following measuring methods can be used to calculate the excess labor hours:

a. Compare the questioned work activity to other similar activities on the same project that occurred during a different time period. (For example, the amount of time needed to pour concrete in one area of the building may approximate the time needed to pour a similar amount of concrete on the same project during a different period of time.)

b. Compare the questioned work activity to the same activity on a different project.

c. Compare the questioned work activity to a formal projected or actual productivity study.

d. Compare recurring work activities to industry standards or manuals.

e. Compare actual costs incurred to estimated or bid comparisons.

f. Engage engineering experts or use manloading studies.

Valuing Excess Labor Hours. After the number of hours of excess time has been estimated, the next step is to extend the number of hours by a labor rate. Use of the following labor rates should be considered:

a. *Actual Labor Rates from the Payroll Journal.* Labor rates that correlate to the period of time that the contractor is claiming the excess hours occurred. One benefit of using this method is that if the labor rates increased because the work did not occur when it was originally planned, the increased rates will already be reflected in the actual labor rates in the payroll journal.

b. *Labor Rates from the Contract.* Sometimes a labor rate for excess hours or for change orders is stated in the contract.

c. *Outside Standard Labor Rates.* Labor rates such as an industry-wide average for the contractor's area. (Industry averages can also be useful in considering the reasonableness of the contractor's actual numbers.)

After the labor is "priced out," any labor-related burdens should be added to the direct labor cost amount. Those burdens are essentially any costs that the contractor allocates based on direct labor cost input. Examples include payroll taxes, insurance (including workers' compensation), or fringe benefits.

Equipment Use Costs. Increased equipment use costs, resulting from idle or inefficiently used equipment, may not be a significant part of a construction claim. However, it tends to be a common part of most *delay* claims. It can also be a significant expense for contractors who have a major investment in expensive equipment, such as roadway construction contractors. In calculating increased equipment use costs, a contractor must first identify the

equipment and periods of "excess" time that the equipment was used. From there, the contractor must value that excess time. A discussion of those steps follows.

Identifying Increased Equipment Use. One method of identifying increased equipment use is to review the timesheets of the direct labor personnel. Often timesheets are designed to indicate the equipment that an employee is using at a particular time. Thus, if it is concluded that certain excess labor hours were incurred, it may be worthwhile to review the timesheets for that "excess time" to see what increased use of equipment may have occurred.

Besides relating excess equipment usage with excess labor hours, it is important to also accumulate the hours that equipment was unused, on the job. It is appropriate to include *downtime* in a damages claim because the equipment could have been used or rented out if it were not at that job site.

Valuing Increased Equipment Use. There are many ways to value increased equipment use. Numerous factors are considered in that valuation, including whether the equipment is rented or owned, whether it is rented from an affiliated company, whether it is usually idle, and whether it is being used on multiple shifts. Also, questions arise as to whether it is more appropriate to use actual costs generated by the accounting department, independent sources of equipment costs, or equipment manuals in the valuation process.

One way to avoid valuation issues is for the owner and contractor to agree in advance on the methods or formulas for pricing claims. Many construction contracts contain clauses establishing contractor reimbursement for equipment costs. If an agreement is not made in advance, various other methods can be used to value the excess equipment use. Those methods are discussed in the following paragraphs.

Internal Rates Established by the Contractor. Increased equipment use can be valued by determining the actual costs for a contractor-owned piece of equipment. Some problems involved with that approach are:

a. At times, not all of the costs associated with a particular piece of equipment are recorded as discrete costs in the accounting records. For example, if a contractor paid cash for the piece of equipment, there would be no actual cost on the contractor's books for the cost of money invested in the equipment.

b. Other costs may be difficult to identify because they are not recorded as direct charges to the cost of the piece of equipment. For example, if improvements to the equipment occurred at various points throughout the equipment's life, it is possible that some of those improvements may be omitted while accumulating "actual" costs.

c. Actual costs can differ significantly between contractors depending on purchase price, depreciation, and allocation policies.

The benefits of developing internal rates for pieces of equipment include:

a. An increase in the accuracy of job cost reports.

b. An enhanced bidding process. (The contractor with better knowledge of what it actually costs to operate certain pieces of equipment can more accurately estimate job costs in the bidding process.)

c. A standard rate for change orders, as well as any claimed damages.

Internal equipment use rates should include *ownership costs* and *operating costs*. Ownership costs are the costs incurred as a function of time and include such things as depreciation, insurance, licenses, property taxes, interest, shop overhead costs, and mechanic's labor costs. Operating costs are those costs associated directly with the daily operating of the equipment. They include such costs as repairs and maintenance, fuel, tires, oil supplies, storage and any other costs specifically associated with maintaining the equipment.

A significant part of the internal rate is depreciation on the equipment. Depreciation represents an allocation of the original equipment cost to the periods of time that the equipment is generating revenue. The depreciation component of actual cost can vary drastically because both the useful life and the salvage value are estimates and there is a variety of depreciation methods available.

Many large equipment intensive companies have not taken the time to develop internal equipment use rates. Thus, it may be quicker or only possible to value increased equipment use by means of external sources.

Equipment Rate Manuals. There are a number of equipment rate manuals used in the construction industry. Some of the more popular manuals include:

a. U.S. Army Corps of Engineers' *Construction Equipment Ownership & Operating Expense Schedule*, available from the website **www.nww.usace.army.mil**/.

b. Equipment Watch's *Green Guide*, available at **www.equipmentwatch.com**/**HomePage.jsp**.

c. Equipment Watch's *Rental Rate Blue Book*, available at **www.equipmentwatch.com**/**HomePage.jsp**.

To effectively utilize the above manuals, consultants should become familiar with the types of costs that are assumed in the rates published by the above sources since the manuals vary significantly as to the types of costs included in the rates. Additionally, the consultant should understand the specific costs included in the rate and the general purpose for which the manual is used. Certain rate adjustments may be necessary depending on the assumptions used in the standard rates. (For example, if a certain type of expense is not included in arriving at a rate but the contractor believes the expense should be included, it may be appropriate to adjust the rate for that expense.) The *Rental Rate Blue Book* is the only guide developed and maintained independent of both owners and contractors.

Other Outside Sources for Valuing Increased Equipment Use. Other external sources include:

a. Actual rental rates incurred, if the equipment was rented.

b. Rental invoices from other projects, if similar equipment was rented for those projects during similar time periods.

It is important to be reasonable when valuing increased equipment use. For example, it would not be reasonable to use equipment rates that bear no relationship to the company's actual costs. It is recommended that the contractor or consultant complete a quick reasonableness test after an equipment value has been determined. One such test might include calculating the percentage value of equipment to total contract value (per the claim) compared to the same percentage on other completed projects.

Active versus Idle Time during Claim Period. A relatively common area of dispute in valuing increased equipment use occurs when the contract performance was delayed for a significant length of time and the equipment was not always in active use, but was in a standby or idle mode. Many times a contractor will claim the full equipment use rate regardless of idle or down time.

The common practice, historically, has been to charge 50% of the standard use rate for the periods of time that the equipment was idle. Standby rates as currently computed by certain state departments of transportation range from 33% to 100% of the full rate. The *Rental Rate Blue Book* suggests using the full depreciation, cost of facilities capital, and indirect costs element components as shown in its rate element tables for standby rates. That essentially excludes the major overhaul component from the standby rate.

Home Office Overhead. All construction projects require home office support to complete the projects. The home office provides services that are essential to operations, including accounting services, marketing, bidding and proposal, administration, and other key functions. The cost of those functions is absorbed by each project. In other words, each project must generate enough *gross profit* to cover its share of the home office and other overhead costs.

A brief review of the chart of accounts can help identify home office overhead costs. Such costs are associated with the contractor's construction operations that are not allocated to the construction projects as direct or indirect costs. They represent the actual amounts that are an essential part of the contractor's doing business, but not charged directly to projects.

At one point, whether a contractor was entitled to home office overhead was subject to debate. In recent years, those costs are regarded by the courts as a fixed or constant expense to be assessed and accepted without question. However, even though entitlement of home office overhead is not usually questioned, the amount of home office overhead allocated to the specific claim has become an area of significant disagreement between contracting parties. The courts have come to favor and disfavor certain methodologies. There are numerous methods to allocate home office overhead costs in a systematic and rational manner. Some of the more common allocation methods are:

a. The Eichleay Formula.

b. Standard percentage of direct costs.

c. Specific base allocation method.

The following paragraphs discuss these allocation methods.

Eichleay Formula. The most common allocation method is known as the Eichleay Formula. It is the preferred method of calculating home office overhead recovery for federal contracting. Additionally, it is popular because of its simplicity and its acceptance in previous court cases. However, the courts have begun to question use of the Eichleay Formula or any other means of assigning additional home office overhead costs to delay claims when use of the formula is not documented as to the relationship that the allocated home office overhead costs have to the specific claim(s). Also, many government contracts are now limiting the use of the Eichleay Formula, either by stipulating a method for home office overhead or directly stating that home office overhead will not be reimbursed. Generally, the courts have allowed the Eichleay Formula when the contractor could not mitigate damages by taking other work during the delay, the delay had to be compensated, and there was a decrease in the flow of income for direct costs that resulted in reduced income available for home office overhead costs.

The Eichleay Formula converts the company's home office overhead into a daily rate for a specific project. Then, the daily rate is multiplied by the number of days of delay to compute the estimated home office damages in the claim. If the contractor performs additional project work during the delay, the overhead reimbursement should be deducted from the daily overhead claim. Exhibit 1-4 presents the steps included in the Eichleay Formula. Exhibit 1-5 illustrates the calculation.

Exhibit 1-4

The Eichleay Formula

Contract billings for disputed contract	÷	Total company billings (a)	=	Project's % of total company billings (a)
Project's % of total company billings (a)	×	Total home office overhead costs incurred (a)	=	Home office overhead allocated to the disputed contract
Home office overhead allocated to the disputed contract	÷	Actual performance days for the disputed contract	=	Daily home office overhead for the disputed contract
Daily home office overhead for the disputed contract	×	Days of delay	=	Total home office overhead damages

(a) During period of contract in dispute.

* * *

Exhibit 1-5

Illustrated Example of Eichleay Formula

	Billings	Cost	Gross Profit (Loss)
Disputed contract	$ 100,000	$ 120,000	$ (20,000)
Other contracts	300,000	240,000	60,000
Total	$ 400,000	$ 360,000	$ 40,000
Total general and administrative costs		$ 30,000	
Days of delay for disputed contract		50	
Actual performance days for the disputed contract		300	

Project's percentage of total company billings—25% ($100,000 ÷ $400,000)

Home office overhead allocated to disputed contract—$7,500 (25% × $30,000)

Daily home office overhead for this contract—$25 ($7,500 ÷ 300 days)

Total home office overhead damages—$1,250 ($25 × 50 days)

* * *

The Eichleay Formula method has the following weaknesses:

a. The "actual performance days for the disputed contract" includes the "days of delay for the disputed contract," which understates the rate and the resulting overhead damages applicable to the delay. For example in Exhibit 1-5, the daily home office overhead for this contract is $25. If the "days of delay for the disputed contract" is omitted from the formula, the daily amount would be $30 [$7,500 ÷ (300 − 50)] resulting in total damages of $1,500 vs. $1,250.

b. All fixed overhead is allocated to the delayed contract based on contract billings. That relationship may not be meaningful because billings do not generate overhead; costs do. In Exhibit 1-5, the disputed contract is allocated 25% of the company's overhead because its billings represent 25% of total billings. If the Eichleay Formula method is applied using cost as a base, the disputed contract would be allocated 33% of the total overhead ($120,000/$360,000).

Also, the method is not as adaptable to a manufacturing setting as it is to the construction environment.

Standard Percentage of Direct Costs. Another approach that is widely used in applying home office overhead to contracts is based on total direct costs. That method is relatively easy to use and may be especially valuable when presenting a claim to a judge or jury. Generally, the method assigns home office overhead to a contract in proportion to the level of direct costs of the contract in comparison to the total direct costs of all contracts. The following example illustrates the method:

Direct costs:	
Disputed contract	$ 30,000
Other contracts	70,000
Total	$ 100,000
Total home office overhead	$ 10,000

Home office overhead rate per dollar of direct costs—$.10 ($10,000 ÷ $100,000)

Home office overhead applied to disputed contract—$3,000 ($.10 × $30,000)

A potential problem in applying home office overhead as a standard percentage of direct costs is that not all contracts have the same mix of direct cost components (direct labor, direct materials, subcontract costs, etc.). Some accountants argue that a contract with a high percentage of subcontract costs to total costs should not receive as much overhead allocation as a contract with a higher percentage of direct labor costs. They believe that a larger portion of the overhead costs actually results from contracts with a higher percentage of direct labor costs. Thus, the method may be most applicable to contractors that use approximately the same mix of direct costs. In addition, the standard percentage of direct costs method may not be appropriate when there are significant contract delays and, as a result, minimal direct cost input.

Specific Base Allocation Method. The specific base allocation method is one of the most precise methods of allocating home office overhead to individual contracts. The method allocates overhead costs based on specific characteristics of each job and each overhead cost element.

The specific base allocation method requires that each home office overhead element of cost be reviewed to determine the most appropriate method of allocating it to a specific project. Different means of assigning costs on different jobs may result in a more appropriate allocation base for a particular contract. For example, capital intensive jobs that require an unusually large amount of electricity might use equipment hours as the most appropriate method of allocating utility costs. On the other hand, it may be more appropriate on labor intensive jobs to use direct labor dollars as the base for allocating utility costs. Examples of home office overhead cost pools and the bases that could be used for allocating them are as follows:

Home Office Overhead Cost Pool	Possible Allocation Base
Utilities	Direct labor hours
Supervision	Direct labor hours
Accounting	Direct labor cost
Marketing	Revenue
Equipment, fuel, and supplies	Equipment hours
Purchasing department and related costs	Direct material dollars

Although the specific base allocation method may, in theory, be one of the soundest approaches, its complexity limits its use. First, most contractors do not need the increased precision that results from the specific base allocation method. Second, formulas usually must be adjusted for each job when there is a high variation in mix of jobs. The cost of doing that is seldom justified due to the high cost of administration. As a result, this method is suitable mostly to large, high-risk projects where there is high potential for litigation of a major claim and the claim needs to be as defensible as possible.

Regardless of the method used to allocate home office overhead, it is important to complete a reasonableness review of the allocated overhead after a damages estimate is complete. A good indicator of the reasonableness of the allocated overhead is a comparison of the bid rate or the percentage used by the contractor in the original budget to the rate claimed as damages. The bid rate established what the contractor anticipated the contract to absorb. If the rates are significantly different, the contractor should reconsider the appropriateness of the allocation method.

Material and Supply Cost Overruns. In many cases, increased material costs from delays and disruptions in the construction process can be minimized. Some material and supply cost claims arise from a contractor assuming one type of material in the bid process and the owner insisting on use of another, higher cost, material. Since the contract may not have been specific, a dispute may arise.

Field Office Overhead. In addition to home office overhead costs, there are certain overhead costs incurred at the job site that should be considered in preparing a claim. Those costs include (but are not limited to) field supervision, trailer office, field telephone, other utilities, and the supervisor's transportation vehicle. Delays can also result in consequential damages to other jobs, for example, because of lack of equipment or experienced crews.

Delays can increase supervision costs because the supervisors may be committed to the project for a longer period of time or may be supervising more employees (resulting in a need for more supervisors). In some cases, a contractor should consider moving certain employees assigned to home office directly to the project, particularly if the employee is spending substantially all of his or her time on the project. Such a move increases the amount of employee cost that might be collectable under a claim.

Profits or Markup on Direct Costs. After a contractor has determined how much cost a particular situation entitles him to, it is reasonable for the contractor to also request a fair profit on the project effort (including increased costs). Profit may be difficult to get, particularly in an arbitration setting where the arbitrator usually wants to please both parties.

Whatever the subjective aspects of the claims process and the litigation strategies, a request for profit should be included in the claim. The request should be supported in the best possible manner. Some methods used to support a claim for profits include comparing the profit proposed on the disputed contract with:

a. Actual profit percentages earned on other similar contracts.

b. The total profit percentage earned on all similar jobs for the past several years. (Loss contracts should be excluded since the project to which the claim relates would have been profitable except for certain acts by the customer or owner.)

There are usually questions as to what base should be used in computing profit. A schedule should be prepared reflecting the contractor's actual final costs and overhead using the same format in which the job was bid. The profit percentage should be applied in the same manner that it would have been at the bid stage had the contractor known what the total costs would be.

Revenue-based Costs. Particular costs, such as certain insurance costs or bond premiums, may be based on a contractor's project or total revenue. As revenue increases, those costs increase accordingly. The contractor should include those increased costs in the claim for damages.

Interest and Financing Costs. Interest and financing costs, referred to as the "cost of money," should be considered in completing a claim. The basis for that component generally includes—

a. Interest calculated on the cost of capital caused by *negative* cash flow during the progress of the work.

b. Interest applied to the total claim from the submission point of the claim to the payment date.

c. Federal and state look-back interest payable on award of the claim. The calculation may be simplified as a percentage and added to the award prior to look-back interest after it is presented and explained to the court, arbitrator, or mediator.

The contractor's borrowing rate with its bank should be the basis for the rate in calculating interest. Benefit should be given for any periods of time the contractor experienced *positive* cash flow during the progress of the work.

Other Miscellaneous Costs. The contractor should also consider the following miscellaneous costs while calculating damages relating to a project:

a. The costs of preparing the claim.

b. Legal or other expert witness costs.

c. Losses associated with decreased or lost bonding capacity.

d. Losses associated with damages to the contractor's business reputation.

Capturing and Documenting Costs. The best information for calculating claims for damages is provided by strong financial and operation recordkeeping systems. To calculate incurred damages, the contractor must be able

to define, accumulate, and calculate the costs clearly and logically. To do that, the contractor must first identify the types of costs incurred and the periods of time incurred. Both of these steps depend on a soundly structured financial reporting system—both for individual projects and for the company as a whole.

A financial reporting system that provides costs by detailed elements, segments, and time periods is essential in supporting *delay* claims. In delay situations, a contractor must be able to prove the impact of the ripple effect (that is, increased costs all the way down the line, resulting from a delay at a given point). A system segregating the costs by segment facilitates such an effort.

Another important source of information for construction claims is the field report. Field reports provide documentation that: (a) clearly defines any problems as they occur, (b) defines the impact of any problems (for example, another effort was delayed due to late drawings), and (c) document any discussions between the owner and contractor that occurred at the time of the problem. Without that information, the effects of delays and disruptions on other segments of the work may be overlooked.

When establishing pricing models for claims or change orders, the CPA must be aware of contract provisions regarding pricing and payment. Failure to recognize costs reimbursed under other contract provisions or included in previous change orders or extra work orders could put the entire claim in jeopardy.

This does not mean that the CPA should under-price a claim or avoid including items that may be challenged. It is important that such items be disclosed and not hidden in the report or in an unexplained pricing formula. In addition, some costs may be reimbursable under different claims or change orders. The CPA must be careful to disclose that if an item is reimbursed in one area, it should be deducted from other claims or change orders.

Penalties for Submitting False Claims. The CPA should be aware of the Federal False Claims Act (31 USC 3729) and related state regulations. The Federal False Claims Act provides that any person or entity that knowingly submits, or causes another to submit, a false or fraudulent claim for payment to a government agency is civilly liable for three times the government's loss plus penalties that range from $5,000 to $10,000 per claim and furthermore may face criminal liability under the Federal Criminal False Claims Act (18 USC 287). Under the Federal False Claims Act, the government does not have to prove specific intent to defraud if false claims are submitted and anyone who causes a false claim to be filed is liable.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. Which of the following is **not** one of the five broad categories that contract disputes are grouped into?

    a. Changes in salaries.

    b. Changes in scope.

    c. Changed conditions.

    d. Disruption.

35. Humboldt Construction has filed a claim for damages under the total cost approach. The claim summary includes the following: total incurred contract costs of $1,000,000, cost assumptions resulting from incomplete subcontractor amounts of $125,000, cost overrun of $85,000, $50,000 deducted for mistakes made by the contractor, cost of capital $35,000, related costs of $20,000 due to cost overrun, and claim preparation costs of $15,000. What is the total due the contractor at the date of the claim?

    a. $1,085,000.

    b. $1,135,000.

    c. $1,155,000.

    d. $1,260,000.

36. Which type of increased cost listed below tends to be a common part of most *delay* claims, but may **not** be a significant part of a construction claim?

    a. Labor and labor-related benefits/burdens.

    b. Equipment use costs.

    c. Home office overhead.

37. The direct costs of the disputed contract are $60,000 and the direct costs of other contracts are $140,000. Thus, the total direct costs are $200,000. With a total home office overhead of $20,000, the home office overhead rate per dollar of direct costs is $0.10. Using the Standard Percentage of Direct Costs method, the amount of the home office overhead applied to the disputed contract is:

    a. $3,000.

    b. $6,000.

    c. $7,000.

    d. $10,000.

38. Which of the following allocation methods is considered the most complex and therefore limited in its use?

    a. The Eichleay Formula.

    b. Standard Percentage of Direct Costs.

    c. Specific Base Allocation Method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. Which of the following is **not** one of the five broad categories that contract disputes are grouped into? **(Page 305)**

    a. Changes in salaries. [This answer is correct. Changes in salaries paid by the contractor to its employees cannot be considered a valid reason to dispute a contract. Salaries are a contractor's internal expenses that they must manage apart from any project they have contracted to complete. some of the contract dispute categories can affect salary expense.]

    b. Changes in scope. [This answer is incorrect. Changes in scope are one of the five broad categories that disputes are grouped into and result from changes to the original plan that severely impact the cost and timing of a project.]

    c. Changed conditions. [This answer is incorrect. One of the five broad categories of disputes is that of changed conditions. These types of claims generally occur when information furnished to the contractor at the time of the bid is different from the conditions the contractor experiences in completing the project.]

    d. Disruption. [This answer is incorrect. Disruption is another of the five categories that disputes can fall into and results from the contractor no being able to perform the work in the manner planned.]

35. Humboldt Construction has filed a claim for damages under the total cost approach. The claim summary includes the following: total incurred contract costs of $1,000,000, cost assumptions resulting from incomplete subcontractor amounts of $125,000, cost overrun of $85,000, $50,000 deducted for mistakes made by the contractor, cost of capital $35,000, related costs of $20,000 due to cost overrun, and claim preparation costs of $15,000. What is the total due the contractor at the date of the claim? **(Page 308)**

    a. $1,085,000. [This answer is incorrect. $1,085,000 includes a deduction of $50,000 for mistakes made by the contractor. This adjustment could be made under the modified total cost approach but not under the total cost approach. The total cost approach essentially requires the contractor to be fault free.]

    b. $1,135,000. [This answer is correct. $1,135,000 is the correct amount of the claim using the total cost approach. The total cost approach submits a claim for damages covering the total cost of completing a construction project plus a reasonable profit and overhead, reduced by amounts already paid by the owner. Thus, the costs stated above that would be included are $1,000,000 in total incurred contract costs, $85,000 in cost overrun, $35,000 for cost of capital, and claim preparation costs of $15,000, for a total of $1,135,000. Other costs identified above would not be included in the total cost approach of claim submittal but could be included in claims submitted using other approaches for calculating contractor damages.]

    c. $1,155,000. [This answer is incorrect. $1,155,000 includes related costs of $20,000 due to cost overrun. Related costs such as this can be used to price damages under the discrete approach to claim pricing where related costs incurred as a result of a specific event can be included, but not in the total cost approach.]

    d. $1,260,000. [This answer is incorrect. $1,260,000 includes cost assumptions resulting from incomplete subcontractor amounts of $125,000. This amount can be included when pricing a claim using the estimated cost approach, but not when using the total cost approach.]

36. Which type of increased cost listed below tends to be a common part of most *delay* claims, but may **not** be a significant part of a construction claim? **(Page 311)**

    a. Labor and labor-related benefits/burdens. [This answer is incorrect. Labor costs and the related benefits/burdens are the most significant aspects of many construction claims.]

    b. Equipment use costs. [This answer is correct. Increased equipment use costs, resulting from idle or inefficiently used equipment, may not be a significant part of a construction claim. Such costs do tend to be a common part of most *delay* claims.]

    c. Home office overhead. [This answer is incorrect. All construction projects require home office support to complete the projects.]

37. The direct costs of the disputed contract are $60,000 and the direct costs of other contracts are $140,000. Thus, the total direct costs are $200,000. With a total home office overhead of $20,000, the home office overhead rate per dollar of direct costs is $0.10. Using the Standard Percentage of Direct Costs method, the amount of the home office overhead applied to the disputed contract is: **(Page 315)**

    a. $3,000. [This answer is incorrect. The amount of the home office overhead applied to the disputed contract would be $3,000 if the direct costs of the disputed contract were $30,000.]

    b. $6,000. [This answer is correct. Since the direct costs of the disputed contract are $60,000 and the home office overhead rate per dollar of direct costs is $.10, the amount of the home office overhead applied to the disputed contract is $6,000.]

    c. $7,000. [This answer is incorrect. Based on the home office overhead rate per dollar of direct costs of $0.10, if the direct costs of the disputed contract were $70,000, the amount of the home office overhead applied to the disputed contract would be $7,000.]

    d. $10,000. [This answer is incorrect. The amount of the home office overhead applied to the disputed contract would be $10,000 if the direct costs of the disputed contract were $100,000.]

38. Which of the following allocation methods is considered the most complex and therefore limited in its use? **(Page 316)**

    a. The Eichleay Formula. [This answer is incorrect. The Eichleay Formula is a popular allocation method because of its simplicity and its acceptance in previous court cases.]

    b. Standard Percentage of Direct Costs. [This answer is incorrect. The Standard Percentage of Direct Costs allocation method is considered relatively easy to use and may be particularly valuable when presenting a claim to a judge or jury.]

    c. Specific Base Allocation Method. [This answer is correct. Although the Specific Base Allocation Method is one of the most precise methods of allocating home office overhead to individual contracts, it is complex in structure and is therefore limited in its use.]

Characteristics of Claim Settlement Support Services That Affect Administration. Several characteristics of claim settlement support services have an effect on the administration of those services. The following characteristics should be recognized:

a. Time scheduling is difficult.

b. Professional standards have limited applicability.

These topics are discussed in the following paragraphs.

Time Schedules. The timetable for delivery of services in a claim settlement support engagement is more changeable and difficult to deal with than for most other types of services CPAs provide. The time schedule is usually seriously affected by the court calendar and the other activities of attorneys on both sides. Claims settlement support work on a particular case can be sporadic, shifting from little or no involvement to intense work on a very short time schedule. The CPA must be responsive to the attorney's and other consultant's needs for services despite the fact that he or she has little control over the peaks and valleys in those needs.

At the start of a claim settlement support engagement, all of the issues and the documents available are not known. As this information becomes available, the CPA can develop a better idea of the time that will be required to review the material and consider the issues. Even with alternative dispute resolution, the schedule can be severely impacted by the arbitrator's or mediator's schedules.

Naturally, once the trial or alternative dispute resolution begins, the CPA may need to devote continuous attention to the engagement. Often the CPA will observe the proceedings during the days and work with the attorney during evenings and weekends. Since these proceedings (particularly in litigation situations) can be all-consuming, work on more than one claim at the same time usually is impossible.

Professional Standards. Ethics Interpretation 101-3 of Rule 101 of the AICPA *Code of Professional Conduct*, (ET 101-5), provides specific guidance on forensic accounting services, including litigation support services. Forensic accounting services are defined in the Interpretation to be "nonattest services that involve the application of special skills in accounting, auditing, finance, quantitative methods and certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings." Forensic accounting services consist of litigation services and investigative services.

Litigation Services. Litigation services consist of—

- *Expert witness services*, in which a practitioner is engaged to provide an opinion before a trier of fact on a disputed matter, based on the practitioner's expertise, rather than his or her direct knowledge of the disputed facts or events. Independence is impaired if a practitioner conditionally or unconditionally agrees to provide expert witness testimony for a client. However, independence is *not* impaired if the practitioner provides expert witness services for a large group of plaintiffs or defendants that includes one or more attest clients of his or her firm provided that, at the beginning of the engagement—

  a. The practitioner's attest clients constitute less than 20% of (1) the members of the group, (2) the voting interests of the group, and (3) the claim;

  b. No attest client in the group is designated as the group's lead plaintiff or defendant; and

  c. No attest client has the sole power to select or approve the expert witness.

  Serving as an expert witness should be distinguished from serving as a fact witness. Fact witness testimony is based on the practitioner's direct knowledge of the disputed facts or events, which may be obtained from the performance of prior professional services for the client. A fact witness provides factual testimony to the trier of fact, thus testifying as a fact witness about a practitioner's opinion on matters within his or her area of expertise would not impair independence.

- *Litigation consulting services*, in which a practitioner provides advice about facts, issues, or strategy but does not testify as an expert witness before a trier of fact. Independence would *not* be impaired by the

performance of litigation consulting services if the practitioner complies with the general requirements of Interpretation 101-3. However, independence would be impaired if the practitioner subsequently agrees to be an expert witness.

- *Other services*, in which a practitioner serves as a trier of fact, special master, court-appointed expert, or arbitrator (including serving on an arbitration panel) in a matter involving a client. Such other services would impair independence. However, independence is *not* impaired if a practitioner acts as a mediator or in a similar role involving a client provided that the practitioner does not make decisions on behalf of the parties, but assists the parties in reaching their own agreement.

Investigative Services. Investigative services are all forensic services not involving actual or threatened litigation but may require the same skills used to perform litigation services, such as performing analyses or investigations. Independence is *not* impaired when performing investigative services as long as the practitioner complies with the general requirements of Interpretation 101-3.

The AICPA has issued other nonauthoritative guidance including:

a. Consulting Services Special Report: *Litigation Services and Applicable Professional Standards* (055297).

b. Consulting Services Practice Aids: *Engagement Letters for Litigation Services* (055298); *Communicating in Litigation Services: Reports* (055000); and *Forensic Accounting—Fraud Investigations* (055305).

Other Guidance. Litigation support standards are also subject to the broad guidance in the consulting services standards and fall under the category "Transaction Services" defined in SSCS No. 1. Several of the ethics rules, such as Rule 102 on integrity and objectivity and Rule 201 on general standards, naturally apply to litigation support services.

Since damage studies often involve the preparation of financial forecasts or projections, a question arises as to the applicability of the AICPA *Statements on Standards for Attestation Engagements* (AT 301) and the related AICPA *Guide for Prospective Financial Information*. Both of those documents state that the guidance does not apply to "engagements involving prospective financial statements used solely in connection with litigation support services." However, even though the AICPA *Guide for Prospective Financial Information* does not specifically apply to litigation support engagements, it can provide useful guidance for developing damage studies that involve projection of future income.

The applicability of the attestation standards to litigation support services is discussed in AT 301 and three attestation interpretations. An interpretation at AT 9101.36–.37 states that the attestation standards apply when accountants are engaged to issue or do issue a report about the reliability of an assertion that is the responsibility of another party.

An interpretation at AT 9101.34–.35 states that the attestation standards do not apply when the litigation services are rendered in connection with the resolution of disputes between parties involved in pending or potential formal legal or regulatory proceedings before a *trier of fact*, (a court, regulatory body, or governmental authority; their agents; a grand jury; or an arbitrator or mediator of the dispute) and when one of the following occurs:

a. The practitioner has not been engaged to issue and does not issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about the subject matter, that is the responsibility of another party.

b. The practitioner is serving as expert witness.

c. The practitioner is the trier of fact or acting on its behalf.

d. The practitioner's work under the rules of the proceedings is subject to challenge and detailed analysis by all parties to the dispute.

e. The practitioner is engaged by an attorney to do work that is protected under the attorney's work product privilege and not to be used for any other purpose.

Practitioners should avoid calling an engagement an examination in any reports to keep from confusing users.

An interpretation at AT 9101.38–.39 clarifies the meaning of the term "stipulated facts" included in the following quote from SSAE Section 101 (AT 101.04c).

> [The following services are not considered attest engagements] Services performed in accordance with the Statement on Standards for Consulting Services, such as . . . engagements in which a practitioner is engaged to testify as an expert witness in accounting, auditing, taxation, or other matters, given certain stipulated facts.

In this sense, *stipulated facts* means facts or assumptions that are specified by one or more parties to a dispute to serve as the basis for the development of an expert opinion. It does not mean facts agreed to by all parties involved in a dispute (which is the typical legal interpretation of the term).

An interpretation of Statements on Standards for Accounting and Review Services (SSARS) addresses the applicability of SSARS to litigation support services (at AR 9100.76–.79). The interpretation clarifies that SSARS generally do not apply to litigation support engagements. SSARS apply when the accountants are:

a. submitting unaudited financial statements of a nonpublic entity that are the representation of management (owners) for use by others who during the legal proceeding are not permitted to analyze or challenge such work, or

b. specifically engaged to submit financial statements that are the representation of management (owners) in accordance with SSARS.

SSARS do not apply when the services are rendered in connection with the resolution of disputes between parties involved in pending or potential formal legal or regulatory proceedings before a *trier of fact*, a condition described above, item b, c, d, or e occurs.

Although the matter is not dealt with explicitly in Statements on Auditing Standards, it generally is recognized in practice that the auditing standards do not apply to the expression of an expert opinion on accounting or auditing issues in litigation. The primary rationale for this exemption of expert opinion from professional standards is that the expert witness is subject to cross-examination, and the expert's opinions can be challenged and tested. If the attestation standards do not apply, Consulting Services Special Report (SR) 03-1, *Litigation Services and Applicable Professional Standards*, states that a CPA should consider disclosing the extent of service provided and the responsibility taken by the CPA, if any.

Staffing and Training. Staffing requirements for consulting engagements depend on the competence level, skills, and experience required for the engagement. The personnel assigned to claim settlement support services need to be relatively well-experienced. For many cases, only a small amount of the work can be performed by staff accountants. Responsibility for claim settlement support services usually should be assigned to a specific partner who will specialize in the area since a familiarity with the administration of claim settlement support services is necessary to generate engagements, make engagement acceptance decisions, and accurately estimate the time requirements of particular engagements.

Billing and Collection. One of the primary attractions of claim settlement support services is that fee discounting is not usually a factor. The monetary stakes in claim settlements are typically high, and clients are less sensitive to cost and more interested in quality work on a time-responsive basis. In complex cases, the expenditure of time can be considerable, and the fees can be commensurately large.

Billing Rates. The billing rates for claim settlement support services vary considerably in practice. However, very few charge less than standard rates. Some CPA firms charge the same rate for claim settlement support as for other professional services; for example, litigation support partners are billed at the standard rate for audit partners. Other firms charge a premium for those services. A 20% premium is relatively common.

Responsible Party. In a claims settlement engagement (particularly at a litigation level), it is important to establish the party that is ultimately responsible for paying the fee. Many times, the CPA is engaged by the attorney on behalf

of the client, who is the plaintiff or defendant. It is recommended that the fee arrangement clearly establish that the attorney is responsible for the fee. That should be true even though in the normal course of events, the attorney bills the client for the expert's services and may act merely as a conduit for the payment. No reputable law firm would attempt to shirk the ultimate responsibility for payment of an expert's fee.

Retainers and Collection. Claim settlement support engagements are usually one-time services, and for that reason a substantial retainer is often advisable. Considerations applicable to use of retainers and billing practices to enhance collection are generally the same as for other consulting services. However, the CPA firm needs to be realistic in establishing collection schedules. Certain types of clients, such as foreign companies, are generally slow-paying. If the CPA firm cannot tolerate any delays in cash flow, engagements for such clients simply cannot be accepted.

Generating Engagements. The very best way to generate claim settlement support engagements is to successfully complete other similar engagements. A CPA who establishes a good reputation as competent, responsive, and professional will be in considerable demand. Claim settlement consultants may obtain some of their work from other CPAs. Other CPAs may prefer not to perform claim settlement services or may not perform claim settlement services for their attest or tax clients. There are also conflict situations that require other CPAs who normally perform claim settlement support work to decline the work. Under those circumstances, they may wish to refer their clients or referral sources to other CPAs whom they believe are credible and competent. It may be appropriate under those circumstances to give the client or referral sources two to four names of individuals or firms with the desired skills.

Normal business relationships are another common source for claim settlement support engagements. Attorneys who have a relationship with a CPA firm through a mutual client will often make referrals for support work if they are aware the firm does that type of work. Also, if a CPA firm refers potential clients to a trial attorney, that attorney will usually reciprocate by referring partners and colleagues to the CPA firm.

When a CPA is attempting to build a claim settlement support practice, consideration may be given to networking with attorneys, claim consultants, and consulting engineers. The CPA may meet with those professionals that the CPA has worked with on other types of engagements to explain how the CPA's firm might be useful in resolving construction disputes. After gaining working experience with those professionals, the CPA may ask them to provide introductions to other business litigation personnel and colleagues, starting the process over again.

Many CPA firms have designed specialized marketing brochures that are used to make attorneys aware of the construction claim settlement support services provided by the firm. The brochures typically contain a description of the types of support the CPA firm offers and the way the firm may be useful to the attorney, a summary of the claim settlement support services previously provided by firm personnel, and other qualifications and expertise of firm personnel. In developing its brochures, the firm should remain aware of the rules and restrictions on advertising. Other ways of making contact with attorneys and other claims settlement professionals include speaking to legal groups and writing for construction contractor publications. However, to be effective, speaking engagements should be targeted to trial attorneys, if possible.

Engagement Acceptance Considerations. Experts generally try to assess the merits of the case from their initial discussions with the attorneys requesting their services. Most experts do not accept cases they consider frivolous or cases with facts they believe they cannot support. Sometimes this assessment is difficult. Thus, many experts use their experience with the attorney to guide them when accepting a case, assuming that the attorney will screen out cases without legal merit and not present them to the expert.

The CPA should consider any possible conflicts of interest with any of the parties involved in the claim. That is an extremely important engagement acceptance consideration. SSCS No. 1 requires that conflicts of interest be disclosed to the client. SSCS No. 1 also requires that the consultant serve the client interest by maintaining integrity and objectivity. If a CPA believes that he or she cannot maintain integrity and objectivity, the engagement should not be accepted.

If the firm is considering providing attest and nonattest services to a client, the firm needs to ensure that all of the applicable requirements of Interpretation 101-3 are met. This applies regardless of whether the client is an existing attest client or a new client for which the engagement will involve attest services.

If the firm is considering providing nonattest services to its public company audit client, the firm should keep in mind that the Sarbanes-Oxley Act of 2002, among other things, prohibits an audit firm from providing its public company audit clients legal services and expert services unrelated to the audit. The SEC rules define legal services as those provided by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided. The Commission defines expert services as services when the accountant could be serving (or could be perceived as serving) in an advocacy capacity. The rules do not prohibit the accountant from performing internal investigations or fact-finding engagements (such as forensic or other fact-finding work that results in the issuance of a report to the audit client). If, after the accountant completes the engagement, the audit client initiates a proceeding or investigation, the audit client and its legal counsel can use the accountant's work product. While the accountant cannot provide additional services, he or she can provide a purely factual account or testimony about the work performed. However, the appropriateness of applying generally accepted accounting principles is prohibited, since that would be a matter of judgment and not a factual account.

The CPA should also identify whether any parties on either side of the claim are existing or former clients. Usually, a CPA firm will not want to accept an engagement if an existing client is on the other side. The CPA firm will need to make a policy decision about whether to accept engagements on behalf of an existing client. A primary disadvantage to acting as a consultant to an existing client relates to the attorney-client privilege. The work performed and information obtained by the existing CPA prior to the time the attorney is retained for the case is not protected by the attorney-client privilege. If the firm decides to accept such an engagement, the work should be clearly delineated by maintaining a detailed log of the work performed for the attorney. When acting as an expert witness for an existing client, the opposing attorney may use the existing relationship and fees obtained for the other services to attack the CPA's objectivity. Also, if one of several defendants is a client, problems can arise if cross-claims among defendants become an issue.

A CPA firm will also need to decide whether to accept an engagement against a former client. Usually, these decisions need to be made on an individual basis and will be influenced by the length of time since the party was a client and whether confidential information obtained in the client relationship may be at issue in the case.

A CPA should also inquire about the identity of all attorneys working on the case, if it is at the litigation stage. It would be, at the least, awkward to be working with an attorney on one claim and against that same attorney on another claim. In larger firms, particularly multioffice firms, it may be desirable to circulate a *Conflict of Interest Search Form* to ensure that all potential conflicts of interest within the firm have been considered.

Engagement Letters. When designing engagement letters, consultants might refer to the nonauthoritative guidance included in the Business Valuation and Forensic and Litigation Services Section Practice Aid 04-1, *Engagement Letters for Litigation Services*. The practice aid makes the following key points:

a. If the CPA serves as a consultant to the attorney, the engagement letter is usually protected by the attorney work product privilege.

b. Engagement letters that contain specific information about the services to be provided can be used by opposing counsel to challenge the CPA's work product and conclusions. A detailed engagement letter may provide the opposing attorney with a road map to the client's litigation strategy.

c. To avoid the problem discussed in b. above, many CPAs restrict their definition of services to broad statements such as, "You have requested that we assist you with analysis and consultation with regard to the XYZ litigation matter as you may direct."

d. The CPA's work product is usually not protected by the attorney work product privilege if the CPA is engaged by the client. Attorneys sometimes prefer to have the engagement letter addressed to them rather than the client. They do so because they wish to protect any privilege extending to the CPA's workpapers and the CPA's discussions with the attorney.

Planning and Budgeting. As the practitioner gains experience in performing claim settlement support engagements, planning and budgeting should become more manageable. In the beginning, it may be helpful to keep in mind that claim settlement support engagements often involve reading depositions, reviewing documents, meeting with attorneys, and studying relevant literature.

For several of the activities involved in claim settlement support engagements, reasonably accurate time estimates should be feasible. Reading of depositions usually can be reduced to a straight calculation of reading rate of pages per hour times number of pages. The reading rate is usually about the same as for a technical manuscript. The CPA should allow more time when there are many complex exhibits. The rate for reviewing documents is often the same as for reviewing audit workpapers. This rate is affected by the legibility of the documents. Time for meetings with attorneys is more difficult to estimate. The CPA might ask about the attorney's expectations on frequency of meetings. The time necessary for studying relevant literature will depend on the number and complexity of the technical issues involved.

An anticipated schedule of when records will be available, when the expert's report/opinion will be required, when the opposing party's expert opinions will become known, and when the trial or arbitration is scheduled will be provided. However, any or all of those scheduled dates may change without notice. It is therefore important for the expert to keep in contact with the attorney who will be aware of scheduling changes that affect the work of the expert.

Although it is possible to estimate the hours involved to complete particular tasks, litigation is often a dynamic situation with shifting requirements and dates for meetings, etc. Accordingly, personnel involved in claim settlement support engagements need to keep their schedules flexible to respond to changing demands of the attorneys.

Written Reports. The need for and extent of disclosure in written reports for claim settlement services should be discussed with the attorney. A written report may be necessary when the attorney needs to present the case to the client to obtain a decision on whether to proceed with the litigation. In that case, the CPA may be asked to prepare a report before discovery. The report should carefully enumerate any assumptions that are necessary because information for the expression of an opinion is not yet available. A written report may also be needed when the attorney believes there are good prospects for a negotiated settlement. The attorney may want to present the report to the opposing attorney to indicate the strength of the case.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

39. If a practitioner is engaged to serve as an expert independent witness in a claims settlement proceeding, which type of services would his testimony be provided under?

    a. Litigation services.

    b. Litigation consulting services.

    c. Investigative services.

    d. Other services.

40. Which of the following key points is valid regarding designing engagement letters as outlined in the nonauthoritative guidance contained in the Business Valuation and Forensic and Litigation Services Section Practice Aid 04-1, *Engagement Letters for Litigation Services*?

    a. Even if the CPA serves as a consultant to the attorney, the engagement letter is generally not protected by the attorney work product privilege.

    b. It is not critical for litigation purposes whether engagement letters contain specific information about the services to be provided or are limited to general information.

    c. Most CPAs attempt to be as specific as possible when describing their definition of services to be provided.

    d. The CPAs work product is usually not protected by the attorney work product privilege if the CPA is engaged by the client.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

39. If a practitioner is engaged to serve as an expert independent witness in a claims settlement proceeding, which type of services would his testimony be provided under? **(Page 322)**

    a. Litigation services. [This answer is correct. A practitioner serving as an expert independent witness in a claims settlement proceeding is doing so under litigation services. An expert witness should not be confused with a fact witness. An expert witness provides testimony based on his or her expertise, rather than on direct knowledge of the disputed facts or events. A fact witness provides factual testimony to the trier of fact, thus testifying as a fact witness about a practitioner's opinion on matters within his or her area of expertise.]

    b. Litigation consulting services. [This answer is incorrect. In the case of litigation consulting services, a practitioner provides advice about facts, issues, or strategy but does not testify as an expert witness before a trier of fact.]

    c. Investigative services. [This answer is incorrect. Investigative services are all forensic services not involving actual or threatened litigation but may require the same skills used to perform litigation services, such as performing analyses or investigations.]

    d. Other services. [This answer is incorrect. Other services include where a practitioner serves as a trier of fact, special master, court-appointed expert, or arbitrator in a matter involving a client.]

40. Which of the following key points is valid regarding designing engagement letters as outlined in the nonauthoritative guidance contained in the Business Valuation and Forensic and Litigation Services Section Practice Aid 04-1, *Engagement Letters for Litigation Services*? **(Page 326)**

    a. Even if the CPA serves as a consultant to the attorney, the engagement letter is generally not protected by the attorney work product privilege. [This answer is incorrect. If the CPA serves a consultant to the attorney, the engagement letter is usually protected by the attorney work product privilege.]

    b. It is not critical for litigation purposes whether engagement letters contain specific information about the services to be provided or are limited to general information. [This answer is incorrect. It is important that engagement letters contain only general information about the services to be provided because letters that contain specific information about the services to be provided can be used by opposing counsel to challenge the CPA's work product and conclusions.]

    c. Because most CPAs are detail-oriented, they tend to be as specific when describing their definition of services to be provided even though doing so exposes them to greater scrutiny by opposing counsel. [This answer is incorrect. Because opposing counsel will use detailed information against the CPA during litigation to challenge the CPAs findings, many CPAs restrict their definition of services to broad statements.]

    d. The CPAs work product is usually not protected by the attorney work product privilege if the CPA is engaged by the client. [This answer is correct. The CPAs work product is usually not protected by the attorney work product privilege if the CPA is engaged by the client. Attorneys oftentimes prefer to have the engagement letter addressed to them rather than the client to protect any privilege extending to the CPA's workpapers and the CPA's discussion with the attorney.]

EXAMINATION FOR CPE CREDIT

Lesson 3 (CONTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

31. Of the following methods of resolving claims relating to construction contracts, which one generally results in the largest time, cost, and uncertainty to the contractor?

    a. Mediation.

    b. Arbitration.

    c. Litigation.

    d. Neutral evaluation.

32. Under the "fast track" arbitration process, the arbitrator will render the award no later than _____ after the conclusion of the hearing.

    a. 7 days.

    b. 14 days.

    c. 21 days.

    d. 30 days.

33. Under the "regular track" arbitration process, the arbitrator will render the award no later than _____ after the conclusion of the hearing.

    a. 21 days.

    b. 28 days.

    c. 30 days.

    d. 45 days.

34. A lack of funds would result in which of the following types of claims?

    a. Delay.

    b. Disruption.

    c. Changed conditions.

    d. Termination.

35. If a contractor determines the actual cost of completing a construction project and claims as damages the total of such costs plus a reasonable profit and overhead, reduced by whatever has already been paid by the owner, the contractor is using which methodology to calculate their damages?

    a. Estimated cost approach.

    b. Total cost approach.

    c. Modified total cost approach.

    d. Discrete approach.

36. The preferred and most common method of calculating home office overhead recovery for federal contracting is:

    a. The Danberry Formula.

    b. The Eichleay Formula.

    c. Standard percentage of direct costs.

    d. Specific base allocation method.

37. The contract billings for a disputed contract are $250,000. The total home office overhead allocated to the disputed contract is $15,000. The actual performance days for the disputed contract total 300 days. The days of delay total 50 days. The daily home office overhead for this contract is $50. Using the Eichleay Formula, what are the total home office overhead damages?

    a. $300.

    b. $833.33.

    c. $1,250.

    d. $2,500.

38. Field office overhead costs at the job-site that should be considered in preparing a claim may include all of the following **except**:

    a. Trailer office.

    b. Meal expenses.

    c. Field telephone.

    d. Field supervision.

39. Forensic accounting services consist of litigation services and investigative services. Litigation services are comprised of expert witness services, litigation consulting services, and a variety of other services. Under expert witness services, independence is impaired if a practitioner conditionally or unconditionally agrees to provide expert witness testimony for a client. Independence is not impaired, however, if the practitioner provides expert witness services for a large group of plaintiffs or defendants that includes one or more attest clients of his or her firm provided that, at the beginning of the engagement the practitioner's attest clients constitute less than _____ of (1) the members of the group, (2) the voting interests of the group, and (3) the claim; no attest client in the group is designated as the group's lead plaintiff or defendant; and, no attest client has the sole power to select or approve the expert witness.

    a. 20%.

    b. 25%.

    c. 30%.

    d. 33%.

40. The billing rates for claim settlement support services vary considerably in practice. Very few charge less than standard rates. Some CPA firms charge the same rate for claim settlement support as for other professional services. Other firms charge a premium for those services. A premium of what percent is considered relatively common?

    a. 15%.

    b. 20%.

    c. 25%.

    d. 30%.

GLOSSARY

Accounts payable: List of debts currently owed by a person or business. These are debts incurred mainly for the purchase of services, inventory, and supplies. The accounts normally do not include accrued salaries payable, accrued interest payable, or rent payable. This list is kept in the ordinary course of the debtor's business.

Accounts receivable: List of money owed on current accounts to a creditor, which is kept in the normal course of the creditor's business and represents unsettled claims and transactions. Accounts receivable normally arise from the sale of a company's products or services to its customers.

Arbitrator: An impartial person chosen by the parties to solve a dispute between them. An arbitrator is empowered to make a final determination concerning the issue(s) in controversy and is bound only by his or her own discretion.

Asset-based lending: Any kind of lending secured by an asset. This means, if the loan is not repaid, the asset is taken.

Attestation engagement: An engagement in which a practitioner is hired to issue written communication that expresses a conclusion about the reliability of written assertions prepared by a separate party.

Attorney work product privilege: Under the work-product doctrine, "tangible material or its intangible equivalent" that is collected or prepared in anticipation of litigation is not discoverable, and may be shielded from discovery by a protective order, unless the party seeking discovery can demonstrate that the sought facts can only be obtained through discovery and that those facts are indispensable fro impeaching or substantiating a claim. That is, the party unable to obtain the information has no other means of obtaining the information without undue hardship.

Collateral: A security or guarantee (usually an asset) pledged for the repayment of a loan if one cannot procure enough funds to repay.

Demand note: (1) Instrument that by its express terms is payable immediately on an agreed-upon date of maturity without further demand for payment. (2) Instrument payable at sight or upon presentation, or one in which no time for payment is stated.

Discovery: The pre-trial phase in a lawsuit in which each party through the law of civil procedure can request documents and other evidence from other parties or can compel the production of evidence by using a subpoena or through other discovery devices, such as requests for production and depositions.

Equity funding: Raising capital by selling part of the ownership, such as stock in a corporation.

Equity investment: The buying and holding of shares of stock on a stock market by individuals and funds in anticipation of income from dividends and capital gain as the value of the stock rises. It also sometimes refers to the acquisition of equity (ownership) participation in a private (unlisted) company or a startup (a company being created or newly created). When the investment is in infant companies, it is referred to as venture capital investing and is generally understood to be higher risk than investment in listed going-concern situations.

Fair market value: The price at which an asset or service passes from a willing seller to a willing buyer. It is assumed that both buyer and seller are rational and have a reasonable knowledge of relevant facts.

Inventory: The value of a firm's raw materials, work in process, supplies used in operations, and finished goods.

Securities and Exchange Commission (SEC): The federal agency empowered to regulate and supervise the selling of securities, to prevent unfair practices on security exchanges and over-the-counter markets, and to maintain a fair and orderly market for the investor.

Working capital: Funds invested in a company's cash, accounts receivable, inventory, and other current assets (gross working capital). It usually refers to net working capital, that is, current assets minus current liabilities. Working capital finances the cash conversion cycle of a business, the length of time required to convert raw materials into finished goods, finished goods into sale, and accounts receivable into cash.

INDEX

A

ALTERNATIVE DISPUTE RESOLUTION 298
- Neutral evaluation 300

AMERICAN ARBITRATION ASSOCIATION 299

ARBITRATION 299

C

CLOSING LETTER
- Financing services engagements 247

COMPANY BACKGROUND
- Company background information 240

CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION 244, 280

CONSULTING—CLAIM SETTLEMENT SERVICES
- Arbitration 299
- Calculating contractor damages
  - Active vs. idle equipment time 313
  - Capturing and documenting costs 317
  - Discrete approach 310
  - Eichleay formula 314
  - Equipment rate manuals 313
  - Excess labor hours 311
  - Field office overhead 316
  - Home office overhead 313
  - Identifying increased equipment use 312
  - Interest and financing costs 317
  - Internal equipment use rates 312
  - Labor and labor-related benefits/burdens 311
  - Material and supply overruns 316
  - Miscellaneous costs 317
  - Overhead allocated by specific base 316
  - Overhead as standard percentage of direct costs 315
  - Overview 307
  - Profits on direct costs 317
  - Revenue-based costs 317
  - Total cost approach 308
  - Valuing excess labor hours 311
  - Valuing increased equipment use 312
- Contract audits 307
- Engagement activities and administration
  - Billing and collection 324
  - Billing rates 324
  - Conflict of interest 325
  - Engagement letters 326
  - Generating engagements 325
  - Planning and budgeting 326
  - Professional standards 322
  - Responsible party 324
  - Retainers 325
  - Staffing and training 324
  - Time schedules 322
  - Written reports 327
- Mediation 298
- Other ADR techniques 300
- Overview 297
- Reasons for claims
  - Changed conditions 306
  - Changes in scope 305
  - Delay 305
  - Disruption 305
  - Termination 306
- Ways to resolve contractor claims 298

CONSULTING ENGAGEMENT ADMINISTRATION
- Financing services 287

CONSULTING—FINANCING SERVICES
- Advertising 258
- Amount of funding needed 260
- Angel investors 265
- Fee considerations 258
- Financing costs 260
- Financing needs 259
- Financing negotiations
  - CPA's role 286
  - Guarantees 285
  - Overview 285
  - Postnegotiation services 286
- Financing proposals
  - Amount of loan 278
  - Checklist of contents 281
  - Collateral 278
  - Description of business 277
  - Financial ratios 280
  - Historical financial statements 279
  - Management profiles 277
  - Personal financial statements of guarantor 280
  - Prescribed forms 281
  - Pro forma financial information 280
  - Proposal summary 277
  - Prospective financial information 279
  - Purpose of loan 278
  - Repayment of loan 278
  - Specific information about requested loan 278
- Generating engagements 257
- Overview 257
- Repayment of funds 260
- Staffing and training 258
- Types of financing
  - Angel investors 265
  - Asset-based lending 263
  - Choosing among alternatives 267
  - Choosing among lenders 268
  - Commercial paper 263
  - Demand note 262
  - Direct placement loans 262
  - Equity financing 264
  - Factoring 263
  - Interviewing potential lenders 268
  - Inventory financing 263
  - Joint venture partnerships 265
  - Layered financing 267
  - Leasing 263
  - Lines of credit 262
  - Long-term financing 264
  - Machinery and equipment financing 263
  - Medium-term financing 263
  - Mezzanine financing 264
  - Mortgage loans 267
  - Overview 261
  - Private sources 261
  - Public offerings 266
  - Receivable financing 262
  - Rent with an option to buy 264
  - Short-term financing 261
  - Small business administration loans 264
  - Small business investment companies 265
  - Term loans 264
  - Venture capital 265

CONSULTING—GENERAL GUIDANCE
- Analyzing information 244
- Applicability of non-consulting services standards to consulting engagements 231
- Consulting services standards
  - General standards 233
- Data collection 243
- Engagement follow-up 248

- Engagement initiation and planning
  - Preliminary surveys . . . 240
  - Understanding the client company . . . 240
- Engagement plans and budgets . . . 241
- Engagement programs
  - Contents . . . 243
  - Staffing requirements . . . 243
- Identifying consulting opportunities . . . 240
- Interviewing . . . 243
- Meetings with clients . . . 244
- Overview of consulting practice . . . 238
- Proposals
  - Contents . . . 241
  - Presentations . . . 242
- Reports
  - Closing letter . . . 247
  - Comprehensive . . . 247
  - Distribution . . . 247
  - Format and content . . . 247
  - Liability considerations . . . 247
  - Preparation . . . 245
  - Presentation . . . 246
  - Review . . . 246
- Time control . . . 244
- Workpapers
  - Analytical approach documentation . . . 245
  - Extent of documentation . . . 244
  - Legal liability considerations . . . 245
  - Reviewing workpapers . . . 246

E

ENGAGEMENT LETTERS
- Construction claims services engagements . . . 326
- Financing services engagements . . . 287

I

INDEPENDENCE
- Consulting services . . . 233

L

LINES OF CREDIT
- Nonrevolving . . . 262
- Revolving . . . 261
- Seasonal . . . 262

LOAN PROPOSAL
- Contents . . . 281

M

MEDIATION . . . 298
- Combined mediation/arbitration . . . 300

P

PRESCRIBED FORMS—FINANCING
- CPA's reporting responsibility . . . 281
- Prescribed forms . . . 281

R

REPRESENTATION LETTERS
- Financing services engagements . . . 288

V

VENTURE CAPITAL
- Financing . . . 265

TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 1—Accounting for Construction Contractors (CONTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   CONTG101 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **July 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

CPE Examination Questions (Lesson 1) 48

CPE Examination Questions (Lesson 2) 108

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Construction Contractors—Course 1—Accounting for Construction Contractors (CONTG101)

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: July 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Construction Contractors—Course 1—Accounting for Construction Contractors

Course Acronym: CONTG101

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Construction Contractors—Course 2—Calculating Income Tax for Construction Contractors (CONTG102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   CONTG102 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **July 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

Page

CPE Examination Questions (Lesson 1) 176

CPE Examination Questions (Lesson 2) 219

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Construction Contractors—Course 2—Calculating Income Tax for Construction Contractors (CONTG102)

CTEC Course No. 3039-CE-0270
Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

CTEC No.: _____

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⊘ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	10.	○	○	○	○	19.	○	○	○	○	28.	○	○	○	○
2.	○	○	○	○	11.	○	○	○	○	20.	○	○	○	○	29.	○	○	○	○
3.	○	○	○	○	12.	○	○	○	○	21.	○	○	○	○	30.	○	○	○	○
4.	○	○	○	○	13.	○	○	○	○	22.	○	○	○	○	31.	○	○	○	○
5.	○	○	○	○	14.	○	○	○	○	23.	○	○	○	○	32.	○	○	○	○
6.	○	○	○	○	15.	○	○	○	○	24.	○	○	○	○	33.	○	○	○	○
7.	○	○	○	○	16.	○	○	○	○	25.	○	○	○	○	34.	○	○	○	○
8.	○	○	○	○	17.	○	○	○	○	26.	○	○	○	○	35.	○	○	○	○
9.	○	○	○	○	18.	○	○	○	○	27.	○	○	○	○					

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: July 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Construction Contractors—Course 2—Calculating Income Tax for Construction Contractors

Course Acronym: CONTG102

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide To Construction Contractors—Course 3—Consulting Services (CONTG103)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

   ONLINE GRADING. Log onto our Online Grading Center at **OnlineGrading.Thomson.com** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

   PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

   Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

   Thomson Reuters
   Tax & Accounting—R&G
   CONTG103 Self-study CPE
   36786 Treasury Center
   Chicago, IL 60694-6700

   You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

   Please allow a minimum of three weeks for grading.

   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

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5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

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Page

CPE Examination Questions (Lesson 1) 254

CPE Examination Questions (Lesson 2) 292

CPE Examination Questions (Lesson 3) 331

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide To Construction Contractors—Course 3—Consulting Services (CONTG103)

Price $79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: ☐ Add $24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ⃠ ⊗ ⊘ .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Expiration Date: July 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide To Construction Contractors—Course 3—Consulting Services

Course Acronym: CONTG103

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⊘ ⊗ ⊘.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes**/**No** ○ ○

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