What Different ACCOUNTING Methods Show Your Surety

BY BERNADETTE BRITZ-PARKER

A contractor's financial condition is critical to the underwriting process. Financial statements must present an accurate picture of a company's financial health.

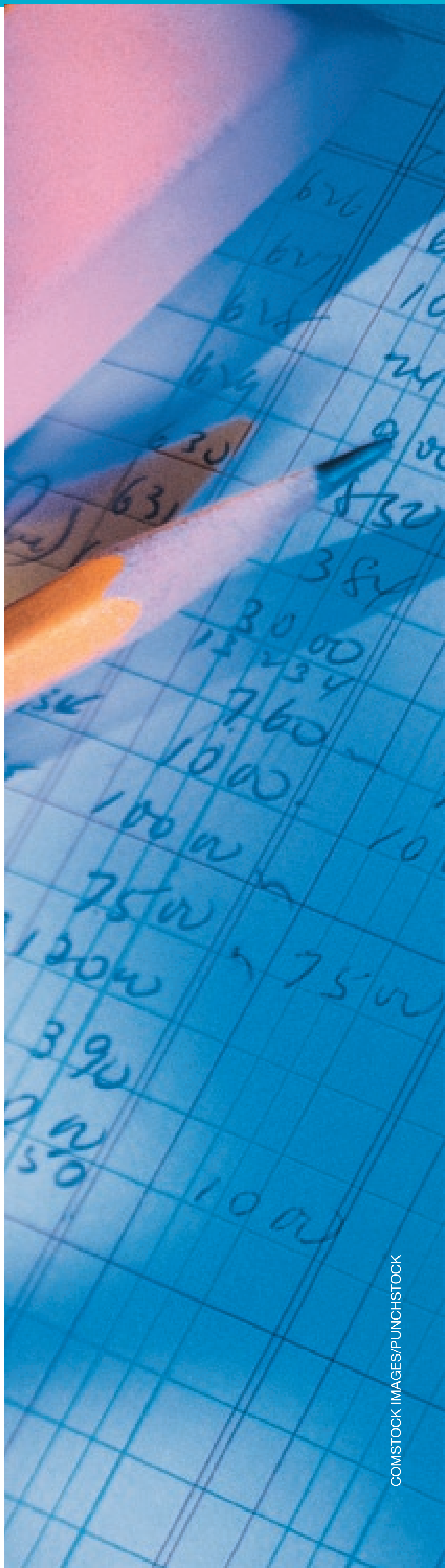
Internally prepared financial statements generally are comprised of a balance sheet and an income statement. The balance sheet includes all assets and liabilities (segregated into current or long term) and equity of the company, and shows a snapshot of a specific date, such as the last day of the year. The income statement, also known as a profit-and-loss statement, includes revenues, expenses and net income for a period of time, such as the month, quarter or year.

Contractors may choose from several different accounting methods depending on the requirements posed by their sureties. Contractors commonly subscribe to three methods: cash basis, accrual and percentage of completion.

CASH-BASIS METHOD OF ACCOUNTING

Cash-basis financial statements are the simplest and least informative of all statements. The balance sheet shows only cash on hand and usually fixed assets and long-term liabilities. The income statement tells only what revenue was received and what expenses were paid. Other current assets or liabilities (e.g., accounts receivable or accounts payable) are not included. This document is based on cash flows and cash position. Revenue is recorded when cash is received, while expense is recognized when the bill is actually paid.

Although this method does not present the true financial condition, it is the simplest method for organizations that do not have a significant amount of transactions or for those with a short lapse between the time service is rendered and payments are made.



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ACCRUAL METHOD OF ACCOUNTING

Accrual-basis accounting is closer to presenting a true financial picture—recording revenues when earned and expenses when incurred. This method requires financial events to be recorded as they relate to net worth. Even though cash is not received or paid in a credit transaction, it is recorded (i.e., as an accounts receivable or an accounts payable) because it affects the financial future of the contractor.

For example, an expense is recorded when an invoice is received, and revenue is recorded when an item is billed. Although this method is more informative than the cash-basis method of accounting, it still is not a true financial picture for a contractor because it does not consider individual contracts, address percent complete, record over-billings or under-billings, or record a loss in full on a contract in process at the moment the contract is known to be a loss contract.

PERCENTAGE-OF-COMPLETION METHOD OF ACCOUNTING

The percentage-of-completion method of accounting is the only method that presents a true financial picture for a contractor involved in long-term contracts. (A long-term contract begins in one fiscal period and is completed in a different fiscal period.)

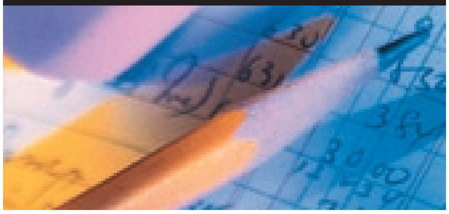
Sureties prefer contractors to use the percentage-of-completion method of accounting for financial statements.

The percent complete generally is determined using the cost-to-cost method, which recognizes contract revenue based on costs incurred to date versus total estimated cost to complete the contract.

For instance, if a contract is estimated to cost a total of $100,000 and $40,000 in costs have been incurred, the job is 40 percent complete. Accordingly, 40 percent of the total contract price should be recognized as revenue. If more than $40,000 has been billed on the contract, the overage is an over-billing, which is a current liability on the balance sheet. Conversely, if less than 40 percent of the total contract price has been billed, the shortage is an under-billing, which is a current asset on the balance sheet.

The best-of-class contractors are over-billed, without exception. Large under-billings generally indicate the contract is a loss contract.

Sureties tend to favor audited financial statements because they are more likely to be materially free of misstatements compared to compilations or reviews.



COMPILED FINANCIAL STATEMENTS

Statements prepared and maintained by an in-house construction contractor provide sureties with the least level of comfort. Prior to settling on this method, it is suggested that a third party, such as a CPA, review the documents to increase their credibility. If a contractor decides to have a CPA issue its in-house financial statements, compiled financial statements are the result.

This document provides a general understanding of the contractor's business transactions and accounting records, the method of accounting used for the financial statements, as well as their form and content. Compiled financial statements also may be issued with or without note disclosures.

These statements provide the fewest representations, as a CPA is not required to verify, corroborate or review the accounting records provided by a contractor. In other words, a CPA is not required to be independent and does not provide an assurance as to the accuracy of the statements, although that lack of independence must be disclosed. If a CPA discovers, during its compilation of financial statements, some items are unsatisfactory for any reason, the CPA must obtain additional or revised information or withdraw from completing the compiled financial statements.

REVIEWED FINANCIAL STATEMENTS

Reviewed financial statements also are prepared by a CPA. Most sureties require reviewed financial statements at a minimum.

These documents provide the surety with a higher degree of assurance because the reliability of the financial statements is determined as a result of various procedures, including primary inquiry and the performance of analytical procedures. However, a review does not include independent third-party verification of contract amounts, change orders or percent-complete or accounts receivable balances.

In a review, a CPA does not document internal control, and therefore has no responsibility to assess the adequacy of the client's system of internal control or test to determine if the system is operating as designed. Additional documents also are generally included, such as a cash-flow statement, schedule of contracts completed, schedule of contracts in process, and detailed notes about a contractor's operations and financial situation. A CPA who is not independent cannot issue a review report.

AUDITED FINANCIAL STATEMENTS

Also known as a financial audit, audited financial statements include an examination by an independent CPA. Depending on the size of a contractor and the amount of bonding needed, many sureties today insist on audited financial statements. This examination results in the publication of an independent auditor's opinion, which declares whether the financial statements are fairly stated, in all material respects, in accordance with generally accepted accounting principles.

Audited financial statements afford the highest level of assurance that the data is fairly presented. Auditing standards dictate the procedures an independent auditor must perform and include documentation and assessment of the system of internal control, assessment of audit risk, independent third-party verification of financial data through confirmations, correspondence with the company's legal counsel, substantive testing of account balances and subsequent event testing through the audit report date.

Audited financial statements presented to a surety typically include:

- Accountant's opinion page that discloses whether the statements were prepared in accordance with generally accepted accounting principles and generally accepted auditing standards.
- Balance sheet that includes the assets, liabilities and net worth of the business as of the date of the statement. This sheet helps a surety evaluate the working capital and overall financial condition of a contractor.
- Income statement that measures how well a business performed during the last fiscal year. A surety analyzes each item, including gross profit on contracts, operating profit and net profit before and after the profit was taxed.
- Statement of cash flow that discloses the cash movements from operating, investing and financing activities.
- Accounts receivable and payable schedules.
- Schedules of contracts in progress and contracts completed that show the financial performance of each contract and provide insight into the potential for future earnings from contracts in progress. This should tie in to the balance sheet.
- Schedule of general administrative expenses that reveals how well overhead expenses are controlled and managed.
- Explanatory footnotes.
- Management letter that conveys a CPA's findings, observations and recommendations about a contractor's financial business. (Not all CPAs provide management letters.)

Financial statements ultimately are only as good as the accountant preparing them.

Contractors also may need to prepare a quarterly schedule of a work in progress. This schedule should list each job by name and include:

- total contract price;
- approved change orders;
- amount billed to date;
- cost incurred to date;
- revised estimate of the cost to complete;
- estimated final gross profit; and
- anticipated completion date.

Sureties tend to favor audited financial statements because they are more likely to be materially free of misstatements compared to compilations or reviews. Auditor assurance reduces information risk in the financial statements and related accounting schedules that accompany a contractor's bond application. As information risk decreases, the surety sees less risk when issuing the bond.

Financial statements ultimately are only as good as the accountant preparing them. This is why it is important to select a CPA who is knowledgeable of construction accounting and the American Institute of Certified Public Accountants' *Audit Guide for Construction Contractors.*

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