

## *New Revenue Recognition Standard* **Manageable Changes for Long-Term Contracts**

For six years now, construction industry leaders and accounting professionals have been nervously following the progress of a new revenue reporting standard that was being developed by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). The new standard had the potential to fundamentally change the way construction companies recognize and report revenue on long-term contracts under U.S. generally accepted accounting principles (GAAP).

After several rounds of exposure drafts and public comments, the final version of the new standard was released earlier this year. Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, represents a major accounting change, but the effects appear to be less tumultuous than originally feared.

Although the effective date is still several years away, any contractor that is required to complete a GAAP-compliant financial statement for investors, lenders or sureties should begin thinking about how to adapt its accounting practices to comply.

### **Percentage-of-Completion and Cost-to-Cost**

ASU 2014-09 reflects a shift from what's known as "rules-based" accounting to a "principles-based" system. There are still rules, of course,

but much of the detailed, industry-specific revenue recognition guidance that construction firms have traditionally relied on is replaced by a set of broad objectives that are designed to ensure good reporting.

Contrary to earlier fears, it now appears most contractors will still be able to use the percentage-of-completion method for recording revenue from long-term contracts. Some of the terminology and technical procedures may be different but, generally speaking, this widely used method will still be permitted.

The final standard also clarifies that most companies can continue using a cost-to-cost approach — calculating the percentage of completion based on the percentage of projected costs that have been incurred. Originally, the proposed standard recommended using an output method that measures the units produced, instead of cost-to-cost. However, it now appears that, with certain exceptions, percentage-of-completion using cost-to-cost will still be allowed.

### **Performance Obligations**

One area of great concern was the proposed requirement that long-term contracts be broken down into a series



of smaller, separate "performance obligations." It originally appeared that contractors would need to allocate the appropriate portion of the total contract price, costs to date, and total anticipated costs to each performance obligation.

This posed particular difficulties in design-build contracts, where services are bundled and integrated rather than segmented. It could also complicate common accounting industry practices such as performance bonuses, change orders and post-completion warranty work.

The final standard, however, specifically states that all contracts do not necessarily have to include multiple

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# Forecasting for Success

## A Process, Not an Event

The construction industry is notorious for its boom and bust cycles. If you don't want to be constantly reacting to these cycles — scrambling to keep up with the work one year, then downsizing the next when things slow down — it's important to plan your company's growth, rather than merely respond to opportunities as they arise.

The first step in this planning process is forecasting. A realistic and credible forecast provides the foundation for all the budgeting and planning steps that follow.

Bear in mind, however, that forecasting is more than a one-time event. Rather, it's an ongoing process that requires regular readjustment and revision. In fact, the forecasting process itself adds value by causing you to challenge your assumptions and analyze the workings of your business to determine what you think is possible, how you're going to achieve it, and what resources you will need to meet your goals.

### The Purpose of the Forecast

The first question you must ask when you begin working on a forecast is "Why?" Why are you forecasting? Are you preparing the forecast as part of your ongoing planning and budgeting process? Or do you need it for a specific purpose, such as getting a loan or preparing your company for sale? While the forecasting process itself will generally be the same regardless of the reason, the level of detail and the way information is presented may differ, depending on the purpose.

The next question to ask is "How much?" And not necessarily

"How much business do we expect?" Rather, the operative question is, "How much profit do we want to produce?" By developing a bottom line target first, you can then begin the process of working backward to determine what steps you need to take to generate enough income to realize this profit.

The forecast is the first step in a recurring cycle. It is used to develop a budget, which in turn provides the basis for developing a detailed operating plan. And the operating plan will reveal areas where your original forecasts may need adjusting, either because conditions changed or because you do not have adequate resources to achieve the forecast results. So the cycle continues.

### Drivers and Followers

Accurate forecasting requires a clear understanding of the driving factors in your business. One obvious driver is revenue. By analyzing historical performance, you can forecast fairly accurately how much overhead, administrative expense, gross margin and net profit will be generated for every dollar of revenue. For greater precision, analyze these figures for various types of projects in order to identify which jobs are more profitable and then adjust your forecast accordingly.

Another major driver is labor. Payroll taxes, workers' compensation, health insurance and payroll administrative costs will follow labor costs very closely. The cost

of direct materials is another key forecast driver, while office supplies and similar SG&A costs are followers. Focus on accurately forecasting the driving factors, and the rest of your forecast will follow.

### Challenge Your Assumptions

Every forecast involves making assumptions. For example, you might assume your job costs will break down into four major categories: 30 percent labor, 30 percent materials, 30 percent subcontractors and 10 percent other.

Accurate forecasting requires that you challenge your assumptions by asking "How?" and "Why?" For example, are you basing your job cost assumptions on historical data? If so, will the new work you are targeting be comparable?

To cite another example: If you are targeting 20 percent revenue growth in the coming year, do market conditions suggest that such growth is possible? Equally important, do you have access to the labor, equipment, capital and other resources you will need to meet that expectation?

If you need additional equipment, do you have adequate capital or credit to acquire that equipment? If you buy it on credit, will the revenue it generates be enough — and will it be collected rapidly enough — to meet your debt service obligations? Or should you lower your revenue forecast in order to avoid creating cash flow problems?

By challenging your assumptions and thinking through their consequences in this way, a forecast becomes more than just a static document. By regularly comparing actual results to your expectations, a forecast becomes a valuable and practical tool that helps you actively manage your company's growth. ■

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*If you would like to learn more about forecasting and business planning, please call us for an appointment.*



## Federal Acquisition Regulation (FAR)

# Understanding What's Needed for Government Work

**G**overnment contracting can be a good source of business, but it's important to understand the special requirements that government projects often entail. All federal government contracts are subject to the Federal Acquisition Regulation (FAR), which spells out required processes and procedures that must be followed to bid on, win and get paid for your work.

FAR requirements are becoming increasingly common on public projects at state and local levels of government, as well. Understanding what's involved is essential if you plan to pursue almost any type of publicly funded contract.

### Varying Requirements

Federal contracts generally contain a provision that allows the government to audit the contractor's billings, underlying costs, fees and rates. FAR Part 31 contains detailed guidance on costs that are reimbursable by the government. This applies to virtually all time-and-materials, cost-plus and reimbursable-type contracts, of course, but even fixed-price contracts are subject to federal audit requirements under the FAR.

Traditionally, the Defense Contract Audit Agency (DCAA) was responsible for performing such audits and reporting back to the contracting agency. Today, however, agencies often require contractors to submit independent audits that verify their compliance with FAR Part 31 overhead cost guidance. Some agencies will require that all contract bids include a FAR-compliant overhead rate, while others will require a copy of your company's audited overhead schedule and related footnotes.

### What You Need to Know

If you learn that a FAR audit will be required, you should consult with your CPA immediately to determine the cost and timing of the audit. In many instances, the audit cost may be a reimbursable expense. If so, you will definitely want to verify this with the contracting agency. If not, you

must evaluate whether this expense is worth incurring in view of the opportunities it can open for bidding on additional projects in the future.

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*Understanding FAR requirements is essential if you plan to pursue almost any type of publicly funded contract.*

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In addition to specific FAR audit procedures and schedules, you should also be familiar with the generally accepted cost accounting standards and controls that the regulation requires. You will need to maintain a job costing system with appropriate controls so that costs are recorded according to accepted definitions and categories, using the correct terminology and coding.

The purpose of a FAR audit is to determine that those requirements are met. Understanding these standards in advance can help you avoid scrambling at the last minute to reallocate costs in order to comply.

In addition to policy compliance, you should also make sure your accounting systems are capable from a technical standpoint. Verify that your accounting system can provide the information the auditor will need to review, in a format that he or she can use, in order to deliver a "clean" FAR compliance opinion without qualifications.

The object is to avoid a last-minute rush to bring your system into compliance when a deadline is looming. ■

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*We can answer your questions about FAR compliance and auditing requirements. Contact our firm today for more information.*

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## New Revenue Recognition Standard

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performance obligations. Performance obligations may be bundled when multiple goods or services are highly interrelated, or when a contractor provides a significant service by integrating multiple goods and services into one combined item. You will need to evaluate each contract to identify whether separate performance obligations exist, and document your conclusions.

### Challenges Remain

Although the final standard is less revolutionary than originally feared, contractors still face some fundamental challenges. For example, the new standard removes certain categories of costs from the revenue recognition calculation, and other costs must now be allocated differently. The new standard will also require significant changes to footnote disclosures. Most contractors' contract and job cost reporting sys-

tems will need some modifications to accommodate these changes.

The new standard goes into effect for publicly traded companies for the first annual reporting period beginning after December 15, 2016. Nonpublic companies may elect to wait until the first annual reporting period after December 15, 2017. For contracts that span these deadlines, contractors can choose from several options for handling the transition.

The earliest deadline is only two years away, so now is the time to start thinking about the changeover — and how you will adapt your accounting practices to comply with the new standard. ■

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*Call us today to discuss these coming changes and what you can do now to prepare.*

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## A 2014 Year-End Checklist

With the holidays upon us and the pace of activities picking up, it's easy to overlook some important things you should do to close out the year. Here are five items to add to your year-end checklist:

**1** Double-check the current status of various tax provisions. New regulations governing repair and maintenance expense deductions went into effect this year, but decisions regarding some other important tax issues were postponed several times. Among these are questions about Section 179 expense deductions, tax credits for research and development, and tax incentives for domestic production (Section 199) and cer-

tain energy-efficiency projects (Section 179D). We are monitoring these developments closely and will keep you informed.

**2** Once the final status of various provisions becomes clear, make an assessment of your company's qualifications for them. Then gather the necessary documentation you will need to claim a credit or deduction.

**3** Look into any state or local tax requirements that may have changed. This is particularly important this year, as many contractors expanded their operations in 2014 and crossed state lines or entered new tax jurisdictions for the first time.



**4** Review the status of independent contractors. Improperly categorizing workers as independent contractors, rather than employees, is always a hot button issue for the IRS. It's wise to review the status of all workers before the end of the year.

**5** Make sure employment records are up to date. Verify you have current addresses and other information for Forms 1099 and W-2. And remind employees that any status change — such as a new baby, a divorce or other major life event — could affect their withholding requirements, so an updated W-4 might be in order. ■



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