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AUDIT & ACCOUNTING GUIDE

Construction Contractors

May 1, 2011

AICPA

Audit & Accounting Guide: Construction Contractors

May 1, 2011

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AUDIT & ACCOUNTING GUIDE

Construction Contractors

WITH CONFORMING CHANGES AS OF

MAY 1, 2011

This edition of the AICPA Audit and Accounting Guide *Construction Contractors*, which was originally issued in 1981, has been modified by the AICPA staff to include certain changes necessary because of the issuance of authoritative pronouncements since the guide was originally issued and other changes necessary to keep the guide current on industry and regulatory matters. The schedule of changes appendix identifies all changes made in this edition of the guide. The changes do *not* include all those that might be considered necessary if the guide was subjected to a comprehensive review and revision.

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Preface

This Audit and Accounting Guide presents recommendations of the AICPA Construction Contractors Guide Committee on the application of generally accepted auditing standards (GAAS) to audits of financial statements of construction contractors. This guide also presents the committee's recommendations on, and descriptions of, financial accounting and reporting principles and practice for construction contractors.

About AICPA Audit and Accounting Guides

This AICPA Audit and Accounting Guide has been developed by the AICPA Construction Contractors Guide Committee to assist management in the preparation of their financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and to assist auditors in auditing and reporting on such financial statements.

The financial accounting and reporting guidance contained in this guide, when developed by the original task force or committee, was approved by the affirmative vote of at least two-thirds of the members of the Accounting Standards Executive Committee, now the Financial Reporting Executive Committee (FinREC). FinREC is the senior technical body of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting. Conforming updates made to the financial accounting and reporting guidance contained in this guide in years subsequent to the original development are reviewed by select FinREC members, among other reviewers where applicable.

This guide does the following:

- Identifies certain requirements set forth in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC).
- Describes FinREC's understanding of prevalent or sole industry practice concerning certain issues. In addition, this guide may indicate that FinREC expresses a preference for the prevalent or sole industry practice, or it may indicate that FinREC expresses a preference for another practice that is not the prevalent or sole industry practice; alternatively, FinREC may express no view on the matter.
- Identifies certain other, but not necessarily all, industry practices concerning certain accounting issues without expressing FinREC's views on them.
- Provides guidance that has been supported by FinREC on the accounting, reporting, or disclosure treatment of transactions or events that are not set forth in FASB ASC.

Accounting guidance for nongovernmental entities included in an AICPA Audit and Accounting Guide is a source of nonauthoritative accounting guidance. As discussed in this preface, FASB ASC is the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the Securities and Exchange Commission (SEC). Accounting guidance for governmental entities included in an AICPA Audit and Accounting Guide is a source of authoritative accounting guidance described in category b of the hierarchy of GAAP for state and local governmental entities and has

been cleared by the Governmental Accounting Standards Board (GASB). AICPA members should be prepared to justify departures from GAAP as discussed in Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01).

Auditing guidance included in an AICPA Audit and Accounting Guide is recognized as an interpretive publication pursuant to AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Interpretive publications are recommendations on the application of Statements on Auditing Standards (SASs) in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB) after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs. The members of the ASB have found this guide to be consistent with existing SASs.

The auditor should be aware of and consider interpretive publications applicable to his or her audit. If an auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he or she complied with the SAS provisions addressed by such auditing guidance.

This AICPA Audit and Accounting Guide, which also contains attestation guidance, is recognized as an interpretive publication pursuant to AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*). Interpretive publications include recommendations on the application of Statements on Standards for Attestation Engagements (SSAEs) in specific circumstances, including engagements for entities in specialized industries. Interpretive publications are issued under the authority of the ASB. The members of the ASB have found this guide to be consistent with existing SSAEs.

A practitioner should be aware of and consider interpretive publications applicable to his or her attestation engagement. If the practitioner does not apply the guidance included in an applicable AICPA Audit and Accounting Guide, the practitioner should be prepared to explain how he or she complied with the SSAE provisions addressed by such guidance.

Recognition

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The AICPA gratefully acknowledges those who reviewed and otherwise contributed to the development of this guide: Kevin Cole, Mike Ellis, Bill Eskin, Robert Mercado, Joe Natarelli, Susan Patton, Don Pfluger, Chris Roemersma, Paul Rohan, Anthony Scillia, Mike Testani, and Paul Tucci.

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Guidance Considered in This Edition

This edition of the guide has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative guidance since the guide was originally issued. Authoritative guidance issued through May 1, 2011, has been considered in the development of this edition of the guide. Authoritative guidance discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before May 1, 2011. Authoritative guidance discussed only in temporary footnotes is not yet effective as of May 1, 2011, for entities with fiscal years ending after that same date.

This includes relevant guidance issued up to and including the following:

- FASB Accounting Standards Update (ASU) No. 2011-03, *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*
- SAS No. 121, *Revised Applicability of Statement on Auditing Standards No. 100*, Interim Financial Information (AICPA, *Professional Standards*, AU sec. 722 par. .05)
- Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .93–.97)
- Revised interpretations issued through May 1, 2010, including Interpretation Nos. 1–4 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 9325 par. .01–.13)

- Statement of Position 09-1, *Performing Agreed-Upon Procedures Engagements That Address the Completeness, Accuracy, or Consistency of XBRL-Tagged Data* (AICPA, *Technical Practice Aids*, AUD sec. 14,440)
- SSAE No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired* (AICPA, *Professional Standards*, AT sec. 301)
- Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, AT sec. 9101 par. .59–.69)
- Public Company Accounting Oversight Board (PCAOB) Auditing Standard Nos. 8–15 (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

Users of this guide should consider guidance issued subsequent to those items in the preceding list to determine their effect on entities covered by this guide. In determining the applicability of recently issued guidance, its effective date should also be considered.

The changes made to this edition of the guide are identified in the schedule of changes in appendix J. The changes do not include all those that might be considered necessary if the guide were subjected to a comprehensive review and revision.

Applicability of U.S. Generally Accepted Auditing Standards and PCAOB Standards

Audits of financial statements of *nonissuers* (those entities not subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, private entities, generally speaking), are conducted in accordance with U.S. generally accepted auditing standards (GAAS) is issued by the ASB, the senior technical committee of the AICPA with the authority to promulgate auditing standards for nonissuers. The ASB develops and issues standards in the form of SASs through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs and their related interpretations are codified in the AICPA's *Professional Standards*. Paragraph .03 of AU section 150 establishes that an AICPA member's failure to follow ASB standards for audits of nonissuers is a violation of Rule 202 of the AICPA Code of Professional Conduct, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01).

Audits of the financial statements of *issuers*, as defined by the SEC (those entities subject to the Sarbanes-Oxley Act of 2002 or the rules of the SEC—that is, public entities, generally speaking), are conducted in accordance with standards established by the PCAOB, a private sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee the audits of issuers. The SEC has oversight authority over the PCAOB, including approval of its rules, standards, and budget.

For audits of a nonissuer, in accordance with both GAAS and PCAOB standards, Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92) provides reporting guidance applicable to such engagements.

References to Professional Standards

In citing GAAS and their related interpretations, references use section numbers within the codification of currently effective SASs and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*). In those sections of the guides that refer to specific auditing standards of the PCAOB, references are made to the AICPA's *PCAOB Standards and Related Rules* publication.

FASB *Accounting Standards Codification*™

Overview

Released on July 1, 2009, FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the Emerging Issues Task Force, and the AICPA) to organize them under approximately 90 topics.

FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a basic view and for an annual fee in a professional view.

Issuance of Amendments to the Codification

Amendments to FASB ASC are now issued through ASUs and will serve only to update FASB ASC. FASB does not consider the ASUs authoritative in their own right; such amendments become authoritative when they are incorporated into FASB ASC.

The ASUs issued are in the form of "ASU No. 20YY-XX," in which "YY" is the last two digits of the year and "XX" is the sequential number for each update. For example, ASU No. 2011-01 is the first update in the calendar year 2011. The ASUs include the amendments to the codification and an appendix of FASB ASC update instructions. ASUs also provide background information about the amendments and explain the basis for the board's decisions.

Pending Content in FASB ASC

Amendments to FASB ASC issued in the form of ASUs (or other authoritative accounting guidance issued prior to the release date of FASB ASC) that are not fully effective, or became effective within the last six months, for all entities or transactions within its scope are reflected as "Pending Content" in FASB

ASC. This pending content is shown in text boxes below the paragraphs being amended in FASB ASC and includes links to the transition information. The pending content boxes are meant to provide users with information about how a paragraph will change when new guidance becomes authoritative. When an amended paragraph has been fully effective for six months, the outdated guidance will be removed, and the amended paragraph will remain without the pending content box. FASB will keep any outdated guidance in the applicable archive section of FASB ASC for historical purposes.

Because not all entities have the same fiscal year ends, and certain guidance may be effective on different dates for public and nonpublic entities, the pending content will apply to different entities at different times. As such, pending content will remain in place within FASB ASC until the "roll off" date. Generally, the roll-off date is six months following the latest fiscal year end for which the original guidance being amended or superseded by the pending content could be applied as specified by the transition guidance. For example, assume an ASU has an effective date for fiscal years beginning after November 15, 2010. The latest possible fiscal year end of an entity still eligible to apply the original guidance being amended or superseded by the pending content would begin November 15, 2010, and end November 14, 2011. Accordingly, the roll-off date would be May 14, 2012.

Entities cannot disregard the pending content boxes in FASB ASC. Instead, all entities must review the transition guidance to determine when the pending content is applicable to them. This Audit and Accounting Guide identifies pending content where applicable. As explained in the section of the preface "Guidance Considered in This Edition," pending content discussed in the text of the guide (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before May 1, 2011. Pending content discussed only in temporary footnotes is not yet effective as of May 1, 2011, for entities with fiscal years ending after that same date.

New AICPA.org Website

The AICPA encourages you to visit the new website at www.aicpa.org. It was launched in 2010 and provides significantly enhanced functionality and content critical to the success of AICPA members and other constituents. Certain content on the AICPA's website references in this guide may be restricted to AICPA members only.

Select Recent Developments Significant to This Guide

Summary of Significant Differences Between the PCAOB and AICPA Risk Assessment Standards

On August 5, 2010, the PCAOB issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). This release includes eight auditing standards (collectively referred to as the PCAOB Risk Assessment Standards) as adopted by the PCAOB. The eight standards, which were approved by the SEC on December 23, 2010, are as follows:

a. Auditing Standard No. 8, *Audit Risk* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

b. Auditing Standard No. 9, *Audit Planning* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

c. Auditing Standard No. 10, *Supervision of the Audit Engagement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

d. Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

e. Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

f. Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

g. Auditing Standard No. 14, *Evaluating Audit Results* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

h. Auditing Standard No. 15, *Audit Evidence* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards)

The release also includes conforming amendments to other interim standards related to the PCAOB Risk Assessment Standards. The effective date of the PCAOB Risk Assessment Standards is for audits of financial statements of issuers with fiscal periods beginning on or after December 15, 2010.

In general, the PCAOB Risk Assessment Standards are consistent with the AICPA SASs related to risk assessment (the AICPA Risk Assessment Standards). Where differences exist, they are primarily due to the PCAOB

a. addressing audits of financial statements in conjunction with audits of effectiveness if internal control (often referred to as integrated audits). The AICPA Risk Assessment Standards only address audits of financial statements.

b. presenting content in standards different than the AICPA Risk Assessment Standards. For example, the PCAOB

   i. incorporated fraud risk assessment procedures into the PCAOB Risk Assessment Standards.

   ii. created Auditing Standard No. 10 to separately address supervision of the audit engagement.

   iii. created Auditing Standard No. 14 to separately address the evaluation of audit results.

   iv. moved content related to other audit areas, such as analytical review procedures and audits of group financial statements.

The PCAOB Risk Assessment Standards are not as voluminous as the AICPA Risk Assessment Standards because the PCAOB standards do not contain as much application guidance as does the AICPA Risk Assessment Standards. Appendix 11 of the release contains a more detailed comparison of the differences between the PCAOB Risk Assessment Standards and the AICPA Risk Assessment Standards.

ASB's Clarity Project

In an effort to make GAAS easier to read, understand, and apply, the ASB launched the Clarity Project. When completed, clarified auditing standards will be issued as one SAS that will supersede all prior SASs. The new auditing standards are expected to apply to audits of financial statements for periods ending on or after December 15, 2012.

The foundation of the ASB's Clarity Project is the establishment of an objective for each auditing standard. These objectives will better reflect a principles-based approach to standard-setting. In addition to having objectives, the clarified standards will reflect new drafting conventions that include the following:

- Adding a definitions section, if relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A prefix and presenting them in a separate section (following the requirements section)
- Using formatting techniques, such as bulleted lists, to enhance readability
- Adding special considerations relevant to audits of smaller, less complex entities
- Adding special considerations relevant to audits of governmental entities

The project also has an international convergence component. The ASB expects that, upon completion of the project, the requirements of GAAS will be converged with those of the International Auditing and Assurance Standards Board. AICPA Audit and Accounting Guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate based on the effective dates.

International Financial Reporting Standards

International Financial Reporting Standards (IFRSs) consist of accounting standards and interpretations developed and issued by the International Accounting Standards Board (IASB), a London-based independent accounting standard-setting body. The IASB began operations in 2001, when it succeeded the International Accounting Standards Committee (IASC). IASC was formed in 1973, soon after the formation of FASB. In 2001, when the IASB replaced the IASC, a new, independent oversight body, the IASC Foundation, was created to appoint the members of the IASB and oversee its due process. The IASC Foundation's oversight role is very similar to that of the Financial Accounting Foundation (FAF) in its capacity as the oversight body of FASB.

The term *IFRSs* has both a narrow and a broad meaning. Narrowly, IFRSs refer to the new numbered series of pronouncements issued by the IASB, as differentiated from International Accounting Standards (IASs) issued by its predecessor, the IASC. More broadly, however, IFRSs refer to the entire body of authoritative IASB pronouncements, including those issued by the IASC

and their respective interpretive bodies. Therefore, the authoritative IFRSs literature, in its broadest sense, includes the following:

- Standards, whether labeled IFRSs or IASs
- Interpretations, whether issued by the IFRS Interpretations Committee (the interactive body of the IFRS Foundation), the International Financial Reporting Interpretations Committee (IFRIC, predecessor to the IFRS interpretations Committee), or the Standing Interpretations Committee (SIC, predecessor to IFRIC)
- IFRS framework

As of March 31, 2010, IFRIC formally changed its name to the IFRS Interpretations Committee, and on July 1, 2010, the IASC Foundation formally changed its name to the IFRS Foundation.

The preface to the IFRS 2010 bound volume states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities including commercial, industrial, and financial entities regardless of legal form or organization. Included within the scope of profit-oriented entities are mutual insurance companies and other mutual cooperative entities providing dividends or other economic benefits to their owners, members, or participants.

IFRSs are not designed to apply to not-for-profit entities or those in the public sector, but these entities may find IFRSs appropriate in accounting for their activities. In contrast, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The AICPA Governing Council voted in May 2008 to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01) of the AICPA's Code of Professional Conduct gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As a result, private entities in the United States can prepare their financial statements in accordance with U.S. GAAP as promulgated by FASB; an other comprehensive basis of accounting such as cash- or tax-basis; or IFRSs, among others. However, domestic issuers are currently required to follow U.S. GAAP and rules and regulations of the SEC. In contrast, foreign private issuers may present their financial statements in accordance with IFRSs as issued by the IASB without a reconciliation to U.S. GAAP, or in accordance with non-IFRS home-country GAAP reconciled to U.S. GAAP as permitted by Form 20-F.

The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession. Acceptance of a single set of high quality accounting standards for worldwide use by public companies has been gaining momentum around the globe for the past few years. See appendix I for a discerning look at the status of convergence with IFRSs in the United States and the important issues that accounting professionals need to consider now.

Private Company Financial Reporting Blue Ribbon Panel and Standard Setting for Nonpublic Entities

The Blue Ribbon Panel on Private Company Financial Reporting was established in December 2009 and was sponsored by the AICPA, the FAF, and the National Association of State Boards of Accountancy. This panel was formed to consider how U.S. accounting standards can best meet the needs of users of private company financial statements. Members of the panel represent a cross-section of financial reporting constituencies, including lenders, investors, owners, preparers, and auditors.

In late 2010, the Blue Ribbon Panel voted to recommend that the FAF accept a new standard-setting model for private companies and the creation of a separate board to set those standards. In January 2011, the Blue Ribbon Panel submitted a report of its recommendations to the FAF. The Blue Ribbon Panel concluded its work upon the issuance of its report to the FAF. For updates of developments regarding standard setting for nonpublic entities visit the AICPA website at www.aicpa.org/privateGAAP.

In March 2011, the Board of Trustees of the FAF announced the establishment of a Trustee Working Group to further address the topic of accounting standard setting for nonpublic entities. The working group has elected to include both non-profit entities and private companies in its consideration of this issue. For more information, visit www.accountingfoundation.org/home.

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Chapter 1

Industry Background

1.01 One of the objectives of revising and updating the 1965 guide for construction contractors was to provide contractors, accountants, and users of financial statements with adequate background material on the nature of the industry, operations in the industry, and its terminology. For that purpose, this chapter describes and discusses the general characteristics of the industry, the operating features of entities in the industry, and the business environment in which they operate.

1.02 This chapter is intended as background for the presentation of recommendations and guidance on financial reporting and auditing in the industry. It does not contain recommendations or guidance on the technical application of generally accepted accounting or auditing standards. Recommendations and guidance on technical accounting and auditing issues are presented in the chapters that follow and include the guidance from subtopic 35, "Construction-Type and Production-Type Contracts," in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605, *Revenue Recognition*.

Nature and Significance of the Industry

1.03 The construction industry consists of individuals and entities that are engaged in diverse types of activities defined as construction in the North American Industry Classification System (NAICS), which replaced the Standard Industrial Classification in 1997. The 2007 U.S. NAICS Manual *North American Industry Classification System—United States* classifies construction establishments into general building contractors (residential and nonresidential), heavy and civil engineering construction contractors (including utility system construction, land subdivision, and highway and street contractors), and 19 different classes of specialty contractors (such as plumbing; heating and air conditioning; and electrical, roofing, and sheet metal work). The data presented indicate that the construction industry is a significant factor in the U.S. economy. It represents hundreds of billions of dollars of economic activity, consists of several hundred thousand business entities widely dispersed throughout the country, employs a large labor force, and contributes a relatively constant percentage (approximately 4.1 percent) to the gross domestic product.

1.04 Construction contractors may be distinguished by their size, the type of construction activity they undertake, and the nature and scope of their responsibility for a construction project. Although the construction industry also encompasses large, multinational contractors that undertake construction of billion-dollar projects, most business entities in the industry are small, local businesses whose activities are limited to a small geographical area. The large number of small entities in the industry may be attributed to the ease of entry into many phases of the construction industry and to the limited amount of capital required. The diverse types of business activities conducted by construction contractors include construction of buildings, highways, dams, and bridges; installation of machinery and equipment; dredging; and demolition. Many entities are able to meet the demands of large construction projects by combining their efforts in joint ventures.

1.05 A contractor may engage in those activities as a general contractor, a subcontractor, or a construction manager. A *general contractor* is a prime contractor who enters into a contract with the owner of a project for the construction of the project and who takes full responsibility for its completion, although he or she may enter into subcontracts with others for the performance of specific parts or phases of the project. A *subcontractor* is a second-level contractor who enters into a contract with a prime contractor to perform a specific part or phase of a construction project. A subcontractor's performance responsibility is to the general contractor, with whom the subcontractor's relationship is essentially the same as that of the prime contractor to the owner of the project. A *construction manager* is a contractor who enters into an agency contract with an owner of a construction project to supervise and coordinate the construction activity on the project, including negotiating contracts with others for all the construction work.

1.06 The organizational structure, resources, and capabilities of contractors tend to vary with the type of activity. Each type of contractor can pose different accounting and auditing problems.

Features of the Business Environment

1.07 Contractors operate in a business environment that differs in some respects from that of other types of businesses. The features of the business environment are discussed in this section in terms of characteristics common to contractors, types of contracts, bonding and surety underwriting, project ownership and rights of lien, contract changes, financing considerations, the use of joint ventures to accomplish objectives, and reporting for financial and income tax purposes.

Characteristics Common to Contractors

1.08 Although the construction industry is difficult to define because of its diversity, as explained in FASB ASC 910-10-15-3, certain characteristics are common to companies in the industry. The most basic characteristic is that work is performed under contractual arrangements with customers. A contractor, regardless of the type of construction activity or the type of contractor, typically enters into an agreement with a customer to build or to make improvements on a tangible property to the customer's specification. The contract with the customer specifies the work to be performed, specifies the basis of determining the amount and terms of payment of the contract price, and generally requires total performance before the contractor's obligation is discharged. Unlike the work of many manufacturers, the construction activities of a contractor are usually performed at job sites owned by customers, rather than at a central place of business, and each contract usually involves the production of a unique property rather than repetitive production of identical products.

1.09 As noted in FASB ASC 910-10-15-4, other characteristics common to contractors and significant to accountants and users of financial statements include the following:

- A contractor normally obtains the contracts that generate revenue or sales by bidding or negotiating for specific projects.
- A contractor bids for or negotiates the initial contract price based on an estimate of the cost to complete the project and the desired

profit margin, although the initial price may be changed or renegotiated.

- A contractor may be exposed to significant risks in the performance of a contract, particularly a fixed-price contract.
- Customers (usually referred to as *owners*) frequently require a contractor to post a performance and a payment bond as protection against the contractor's failure to meet performance and payment requirements. Most governmental owners, by law, are required to have the contractor post these bonds; other owners have the option of either having the contractor post the bonds or not.
- The costs and revenues of a contractor are typically accumulated and accounted for by individual contracts or contract commitments extending beyond one accounting period, which complicates the management, accounting, and auditing processes.

Types of Contracts

1.10 The nature of a contractor's risk exposure varies with the type of contract. As identified in FASB ASC 605-35-15-4, the four basic types of contracts used in the construction industry based on their pricing arrangements are fixed-price or lump-sum contracts, unit-price contracts, cost-type (including cost-plus) contracts, and time-and-materials contracts, which are defined in the FASB ASC glossary and further described as follows:

- A *fixed-price contract*, also known as a *lump-sum contract*, provides for the contractor's performance of all work to be performed under the contract for a stated price, which is not usually subject to adjustment because of costs incurred by the contractor.
- A *unit-price contract* provides for the contractor's performance of a specific project at a specified price per each unit of output. This type of contract is commonly associated with road building.
- A *cost-type* (including a *cost-plus*) *contract* provides for reimbursement of allowable or otherwise defined costs incurred plus a fee for the contractor's services that represents profit. Usually, the contract only requires that the contractor's best efforts be used to accomplish the scope of the work within some specified time and stated dollar limitation. Cost-type contracts take a variety of forms. The contracts often contain terms specifying reimbursable costs, overhead recovery percentages, and fees. The fee may be fixed or based on a percentage of reimbursable costs.
- A *time-and-materials contract* is similar to a cost-plus contract and generally provides for payments to the contractor on the basis of direct labor hours at fixed hourly rates (the rates cover the costs of indirect labor and indirect expenses and profit) and cost of materials or other specified costs.

1.11 All types of contracts may be modified by target penalties and incentives relating to factors such as completion dates, plant capacity on completion of the project, and underruns and overruns of estimated costs.

Bonding and the Surety Underwriting Process

1.12 Contractors bidding on or negotiating a contract may be required to make a deposit for the use of the plans and specifications for the project. Before

they are allowed to submit bids, those seeking prime contracts may be required to post a bid bond or make a deposit, usually in the form of a bank-guaranteed check, equal to a percentage of the total cost estimated in the feasibility study. On virtually all public work and on some private work, bid security is usually required to provide some assurance that only qualified, responsible contractors submit bids. In the construction industry, bid bonds, as well as performance bonds and payment bonds, are provided by surety companies.

1.13 A bid bond issued by a surety does not guarantee that the contractor will sign a contract or guarantee that the surety will issue a performance bond. The contractor and surety promise the owner that if the contractor who is awarded the contract does not sign the contract or cannot provide a performance bond, the surety will pay, subject to the maximum bid bond penalty, the difference between the contractor's bid and the bid of the next lowest responsible bidder. The bid bond or deposit protects the owner from bidders without the resources necessary to complete the work and gives the owner a certain amount of indemnity against the cost of rebidding or finding another contractor who can complete the work. A surety required to pay on a defaulted bid usually has the right of recovery against the contractor's assets.

1.14 After being awarded a contract, a contractor may be required to post a performance bond, also issued by a surety. The performance bond provides protection against the contractor's failure to perform the contract in accordance with its terms. The surety's obligation under the bond terminates on satisfactory completion of the work required by the contract. However, if the contractor should fail to perform in accordance with the contract, the surety is obligated to the owner for losses but usually has recourse against the contractor's assets.

1.15 A payment, or labor-and-materials, bond is commonly provided by sureties as a companion to the performance bond. The protection provided by a payment bond is governed by state laws, which vary widely but generally cover the contractor's labor, subcontractors, and suppliers. The Miller Act of 1935 requires general contractors on federal government projects to post payment bonds to protect suppliers of labor, materials, and supplies to those projects. This type of bond generally applies to work already performed.

1.16 In providing the various types of bonds required in the construction industry, the primary function of sureties is to prequalify the contractor. The surety examines the contracting entity to determine if it has the management, experience, equipment, and financing capability to get the job done. If, in the judgment of the surety, the contractor can perform the contract, the surety will provide the required bonds. Similarly, the contractor may wish to evaluate the quality and capability of the surety, including the financial stability of the surety.

1.17 Surety underwriting is similar to, yet different from, insurance. Insurance involves a two-party agreement in which a premium is paid to protect an insured party from the risk of certain types of losses. In contrast, a surety bond involves a three-party agreement in which the surety and the contractor join together to provide protection against losses to a third party. Surety underwriting is also similar to extending credit. For a fee, the surety provides a guarantee to third parties that the contractor will fulfill obligations of performance and payment. Just as a banker will not knowingly make a loan without satisfying himself regarding a borrower's ability to repay the loan in accordance with its terms, a surety will not knowingly issue a surety bond without similar

knowledge of the contractor's ability to meet obligations in accordance with the terms of a contract.

Project Ownership and Rights of Lien

1.18 A contractor may be required to make a significant commitment of resources to a project under construction. His ability to recover his investment may be impaired by certain peculiar considerations. The project is ordinarily one of a kind and is built on the owner's site. The owner has title to the real estate as well as all improvements as the contractor provides them. The contractor acquires materials for specific projects and has no direct ownership claims to the work in progress. Subassemblies fabricated on the contractor's premises usually have little value to him or her because of the uniqueness of the project.

1.19 As a special remedy for these conditions, the laws of most states protect providers of labor and materials, such as contractors, from the failure of the owner to pay by granting a right of lien. Under a right of lien, contractors have a claim against the real property, although that right is not necessarily senior to other claims, such as the rights of mortgage holders. Because lien rights are lost if they are not perfected within a limited time period, contractors ordinarily have an established procedure for filing claims before the expiration of those rights. Federal government property ordinarily is not subject to lien under state law, but suppliers, other than general contractors, of labor and material for such property are normally protected by payment bonds that the general contractor is required to post under the Miller Act of 1935.

Contract Changes

1.20 Management control of change orders, claims, extras, and back charges is of critical significance in construction activity. Modifications of the original contract frequently result from change orders that may be initiated by either the customer or the contractor. The nature of the construction industry, particularly the complexity of some types of projects, is conducive to disputes between the parties that may give rise to claims or back charges. Claims may also arise from unapproved change orders. In addition, customer representatives at a job site sometimes authorize the contractor to do work beyond contract specifications, and this gives rise to claims for "extras." The ultimate profitability of a contract often depends on control, documentation, and collection of amounts arising from such items.

Financing Considerations

1.21 The methods of financing operations in the construction industry have developed in response to the nature of the industry and the business environment in which it functions. The cost and availability of financing are affected by the risks to which contractors are susceptible. The greatest risk factor in the industry stems from the method of pricing. A contractor, unlike a businessperson in most other industries, normally must set his or her prices in the bidding or negotiating process before product costs are absolutely determined; and the prices, particularly for fixed-price contracts, are not necessarily subject to modifications solely because of changes in costs.

1.22 A contractor's greatest financing need is working capital. Term loans to support working capital needs are rare because expansion can usually be supported by working capital loans on a contract-by-contract basis. Banks and other credit grantors typically require more tangible types of security for term

loans than most contractors can furnish. However, contractors use chattel loans, which may be tailored to match payments with cash receipts (such as by a waiver of payments during off-season periods), to finance equipment purchases.

1.23 In addition to a traditional line of credit, a working capital line of credit on specific contracts is another short term financing option often available to contractors. Working capital loans are usually advanced on a contract as needed to pay for materials, labor, and subcontract costs. Such loans are a necessary means of financing for most contracts because of the lag between expenditures and the receipt of cash. The credit grantor may take an assignment of the contract and the related receivables; however, a bonding company, if one is involved, has rights to the receivables that take precedence over those of other creditors, including a secured lender. Credit grantors often require that the proceeds of contracts be assigned to them and may also require that the proceeds of the loan be paid directly to suppliers as invoices are submitted.

1.24 Contractors may qualify for government-sponsored programs that support or guarantee financing for small or minority-owned businesses. The programs generally guarantee lines of credit on a contract-by-contract basis. Those programs, under which the contract proceeds are usually assigned to the creditor, are ordinarily available only to contractors that would not qualify for working capital loans from banks without some form of government guarantee.

1.25 Some contractors finance bid deposits with temporary bank loans that are usually repaid by the return of the bid check. Because a bank-guaranteed check used as a bid deposit can be forfeited if a contractor who is awarded a contract cannot obtain the required bonding or withdraws from the contract, a contractor usually obtains a commitment for the required bonding before bidding on a project.

1.26 Billing practices in the industry have evolved from the need to generate cash flows in order to finance the progress of construction projects. In contrast to manufacturing entities, whose billing practices are fairly standard, with the customer billed on shipment of the goods, billing practices in the construction industry vary widely and often are not correlated with the performance of the work. Billing arrangements are usually specified in the contract and vary with the different types of contracts used in the industry. The amount and timing of billings under contract may be based, for example, on such measures as

- completion of certain stages of the work.
- costs incurred on cost-plus contracts.
- architects' or engineers' estimates of completion.
- specified time schedules.
- quantity measures of unit price contracts, such as cubic yards excavated.

1.27 In any event, progress billings or customer advances on contracts provide a significant source of financing for most construction contractors. Most contracts, however, call for retention by the owner of a specified amount of each progress billing, often 10 percent, until the job reaches an agreed-upon state of completion, with a provision for a reduction thereafter. The purpose of retentions is to ensure performance of the work in accordance with acceptable quality standards or to protect the owner against the cost of obtaining another contractor if a contractor fails to complete the work.

1.28 A contractor ordinarily will try to assign a higher relative bid price to job components that he or she expects to complete early in the job. The practice of unbalanced bidding, which is referred to as *front-end loading*, accelerates the contractor's cash receipts on a contract and represents a significant financing strategy for many contractors.

1.29 Front-end loading and other types of unbalanced bidding are often viewed with concern by those not familiar with the industry, but they are common practices that contractors use to assist in the financing of jobs. Money management is a vital part of construction management, and unbalanced bidding is one of the key tools. Negotiation of advantageous cash payment terms at the bidding stage, and other procedures to accelerate cash collection, are significant financing considerations in the industry. However, the contractor needs to be aware that, as a result of unbalanced bidding, cash inflows at the end of the contract may be less than cash requirements. Therefore, appropriate controls and cash budgeting are an essential part of financial management. An increasing number of credit grantors are requiring contractors to furnish cash projections on contracts before they will extend credit.

Joint Ventures

1.30 According to the FASB ASC glossary, a *joint venture* is an entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A joint venture usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly.

1.31 In the construction industry, ownership of joint ventures may take several forms. The most common are corporate joint ventures, partnerships, limited liability corporations, and other types of pass-through entities. Contractors frequently participate in joint ventures with other parties on construction projects to share risks, combine the financial and other resources and talents of the participants, or obtain financing or bonding. In the construction industry, joint ventures often include arrangements for pooling equipment, bonding, and financing and for sharing skills such as engineering, design, and construction.

1.32 The rights and obligations of each joint venturer, the scope of the joint venture's operations, and the method of sharing profits or losses of the joint venture are typically set forth in the joint venture agreement. A joint venture provides for the sharing of profits and losses in a variety of ways and may not be related to the method of sharing management or other responsibilities. Accomplishing objectives through joint ventures is often a significant business strategy for construction contractors, and management control of such activity can have a significant effect on the contractors' operations.

Reporting for Financial and Income Tax Purposes

1.33 Because of the large number of small enterprises in the construction industry, construction contractors' financial statements are used most frequently for credit and bonding purposes. Such a use is often accompanied by a request for supplemental information, including a job-by-job analysis of the recognized gross profit of both completed and uncompleted contracts allocated between reporting periods, a breakdown of general and administrative expenses,

job costs, and a summary aging of accounts receivable. Recognition of revenues for these financial presentations is governed by accounting conventions described elsewhere in this guide and in FASB ASC 605-35.

1.34 On the other hand, business realities demonstrate that the gross profit is not certain, nor irrevocably earned, until the contract is actually completed and accepted. In addition, final collection, particularly of retentions, usually takes place sometime after the earning process that is recognized in the financial statements.

1.35 Some contractors adopt income tax reporting practices that are sensitive to the uncertainties of the estimating process and that more nearly relate to the timing of cash receipts and disbursements. This usually means the adoption of methods that defer income recognition until contracts are completed; the use of the modified accrual basis, which reports retentions only when received; or the use of the cash basis.

Typical Industry Operations

1.36 Because the industry consists of diverse types of entities engaged in various types of work that may change over time, users of the guide need to understand not only the industry but also the operation of the individual entity with which they are concerned. For that reason, a description of the process of obtaining and initiating a project is useful to identify unusual conditions that require special consideration in preparing, auditing, or using the financial statements of a particular construction contractor.

Preparing Cost Estimates and Bids

1.37 The process leading to the preparation of estimates and bids on a project usually is initiated by the entity that engages a construction contractor for a project. When a customer, usually referred to as an owner, decides to construct a new facility, an architect or engineer may be engaged to prepare preliminary plans and cost estimates for the project. If preliminary procedures indicate the project is feasible, plans and specifications are prepared in sufficient detail for the preparation of cost estimates.

1.38 The owner may negotiate for a price with several general contracting firms or may advertise for bids. Bidders may be limited to those who can meet specified prequalification standards regarding financial capacity, experience, and availability of specialized equipment and who can furnish a bid, payment, or performance bond or all three types of bonds. The owner may decide to use one contractor as a prime contractor responsible for all phases of the work or to grant separate prime contracts for certain specialized portions of the work, such as electrical work, mechanical work, special equipment, and elevators.

1.39 Before tendering a bid, the contractor's estimating department prepares a cost estimate by examining the plans and specifications to determine the quantities of materials, the hours of various labor classifications, and the type and hours of use of the equipment necessary to perform the work. Quantity surveys, or takeoffs of the quantities of materials required for the job, prepared by the design firm or an independent agency, are often available for the contractor to use as a check on his own estimating department.

1.40 The equipment demands of a contract affect a contractor's bidding, projected need for funds, and financing strategy. Some types of construction

require extensive use of costly equipment, and contractors are faced with decisions to buy or lease the equipment. Such decisions are often complicated because equipment may be acquired and tailored for use on a specific job and because the contractor may not be able to use the equipment on other jobs. In these situations, a contractor is then faced with a decision to either capitalize the equipment or cost it out to the specific job.

1.41 Phases of the job (such as excavating, erecting steel, and roofing) not done directly by the contractor are offered to various trade or specialty subcontractors who, in turn, prepare bids to the prime contractor for their portions of the work. Each phase of the work may be bid on by more than one subcontractor, who may submit bids to more than one prime contractor. In dealing with different prime contractors, a subcontractor may vary the amount of the bids according to his or her assessment of his or her past experience with each contractor in terms of payment policies, quality of supervision and job coordination, and negotiating pressures.

1.42 Once the estimated cost of the work is determined, the contractor determines the amount by which the estimated cost will be marked up. The markup may vary between elements of the work, such as labor, material, subcontractor costs, or equipment. In determining how much the bid will be marked up over cost, the contractor ordinarily evaluates several factors including, but not limited to, the following:

- The complexities of the job
- The volatility of the labor and materials markets
- The contractor's experience, or lack of it, in doing the kind of work involved
- The reputation of the design agency for reliability and completeness of plans, as well as its reputation for reasonableness in its dealings with contractors
- The season and weather
- The predicted working relationship with the owner
- The probability of opportunities to negotiate profitable changes to the contract
- The alternate construction methods or specifications included in the bid request
- The competition and the market
- The incentive or penalty provisions of the contract
- The anticipated cash flow characteristics of the job
- Other peculiar risk conditions, including warranty requirements

1.43 After determining the total bid price, the contractor normally should estimate the timing of disbursements for the job and the cash resources available to determine the allocation of the contract price among the progress billing points called for in the contract.

Entering Into the Contract

1.44 The owner evaluates the bids received and may choose to sign a contract with the low bidder or to negotiate further, depending on the terms of the invitation to bid, statutes governing the bidding process of either public or private bodies, and other possible considerations. Submitted bids may be a

matter of public record, and the bids of other contractors can provide a valuable, independent check on the accuracy of the contractor's estimating department. At some stage, an agreement is reached between the owner and the contractor that enables the contractor to proceed with the work. The formal signing of a contract is usually not a specific point before which all effort is selling and after which all effort is construction. Negotiation is likely to continue during the entire cycle; the signed contract represents the basic understandings and undertakings of both parties, but many contract modifications, not necessarily in writing, may be made during the progress of the job. A given situation can be covered by different types of contracts, and the risks and concerns may be different for each contract type.

Planning and Initiating the Project

1.45 Before construction begins, the contractor usually moves equipment to the job site, erects a temporary field office, and installs temporary utilities. The purchasing department proceeds with the selection of material suppliers and subcontractors and converts their bids to written contracts or purchase orders. The authority and responsibility for the performance of the work on a project usually rest on one individual known as the *project manager*.

1.46 The management organization of construction contracting entities varies considerably, depending on the size of the contractor, the complexity of the projects performed, and other factors. In some entities, the person responsible for bidding a contract is also responsible for the performance of the job. This sometimes means that there is no separation of functions among selling, pricing, and production and that the entity is a conglomerate of small profit centers sharing, perhaps, a pool of equipment and an administrative staff. In other entities, a separate department is responsible for selecting jobs to estimate, preparing bids, and executing contracts. When the entity obtains a contract for a project, a member of the production staff is assigned the responsibility as project manager. Before accepting responsibility for the profit on the project, the project manager often prepares a schedule and budget that may include a complete reestimate of the cost of the job. This procedure provides an additional control and allows the contractor to fix the responsibility for profit on a contract.

1.47 The cost reporting system for the job is usually established at about the time the work begins. The coding system may be standard throughout the entity or redesigned for each individual job, but it should conform closely to the cost categories established in the original estimate or to the categories developed in the production plan, if one is prepared. A production plan or budget that is costed out in detail is helpful because it enables the contractor to compare costs by categories to the cost standards set before beginning the work.

1.48 On most construction projects, the major construction activity is carried out at the job site. The size and location of some projects make it necessary for a contractor to establish an administrative office at the job site and conduct most control and accounting functions from that office.

Variations in Size and Methods of Operation

1.49 The preceding discussion of operations is typical of a medium-sized general contractor with a small number of significant contracts; it illustrates the importance of planning, bidding, and estimating. Construction activity,

however, involves all types and sizes of contractors, and the management and operations of a contractor vary with the size and type of contractor. Many contractors have a mix of jobs that includes a few large jobs and many small jobs, including fixed-price and cost-plus contracts. Service-type contractors seldom are involved in bidding for contracts. Most of their small contracts originate as service calls, and many of their large contracts result from service calls and are negotiated rather than bid.

Project Management

1.50 The quality of management is a key determinant of the success or failure of a contractor. The management objective is to develop and maintain the ability to produce reasonable and competitive cost estimates on contracts and to complete the work required by the contracts within those cost estimates. Because success is determined by the results on contracts, many contractors project the effects that every transaction and event will have at the completion of the contract and use fluctuations of the final estimated profit as the stimulus for management action. Project management requires all the functions involved in planning, acquiring, controlling, and performing a project. All the following functions are involved:

- Resource planning
- Project start-up
- Estimating
- Scheduling
- Project administration
- Technical performance
- Procurement and material planning
- Labor planning and control
- Subcontractor management
- Support equipment and facilities
- Project accounting
- Project management reporting
- Operations analysis

Although some of these functions overlap, all are performed on every project undertaken by a contractor, even though the specific functions may not be identified. A large contractor may assign each function to a separate department, whereas a small contractor may assign two or three people responsibility for all the functions or may engage parties outside the organization to perform some of the functions on a consulting basis.

Chapter 2

Accounting for Performance of Construction-Type Contracts

2.01 This chapter covers accounting for performance of construction-type contracts and other general accounting considerations. Chapter 3, "Accounting for and Reporting Investments in Construction Joint Ventures," chapter 4, "Financial Reporting by Affiliated Entities," chapter 5, "Other Accounting Considerations," and chapter 6, "Financial Statement Presentation," respectively cover joint ventures, reporting by affiliated entities, interperiod tax allocation, and financial statement presentation. The guidance on accounting for construction-type contracts set forth in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35 is summarized in this chapter of the guide.

2.02 Contracts covered are *construction-type contracts*, as defined in FASB ASC 605-35-15. The classification of contracts covered in that section and the definition of a contractor and the concept of a profit center contained in FASB ASC 605-35-20 also apply to the discussion in this guide.

Basic Accounting Policy for Contracts

2.03 The choice between the two generally accepted methods of accounting for contracts is the basic accounting policy decision for construction contractors. The circumstances in which the percentage-of-completion and the completed-contract methods are preferable are set forth in FASB ASC 605-35 and are summarized in this chapter. FASB ASC 605-35-25-1 clarifies that the determination of which of the two methods is preferable is based on a careful evaluation of circumstances because the two methods should not be acceptable alternatives for the same circumstances.

Percentage-of-Completion Method

2.04 FASB ASC 605-35-25-57 states that the percentage-of-completion method is preferable as an accounting policy when estimates are reasonably dependable and all of the following conditions exist:

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

2.05 As provided in FASB ASB 605-35-25-58, the presumption is that, for entities engaged on a continuing basis in the production and delivery of goods or services under contractual arrangements and for whom contracting represents a significant part of their operations, they have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. It also states that persuasive evidence to the contrary is necessary to overcome that presumption. FASB ASC

605-35-25-60 states that the percentage-of-completion method should be applied to individual contracts or profit centers, as appropriate, based on all of the following considerations:

a. Normally, a contractor will be able to estimate total contract revenue and total contract cost in single amounts. Those amounts should normally be used as the basis for accounting for contracts under the percentage-of-completion method.

b. For some contracts, on which some level of profit is assured, a contractor may only be able to estimate total contract revenue and total contract cost in ranges of amounts. If, based on the information arising in estimating the ranges of amounts and all other pertinent data, the contractor can determine the amounts in the ranges that are most likely to occur, those amounts should be used in accounting for the contract under the percentage-of-completion method. If the most likely amounts cannot be determined, the lowest probable level of profit in the range should be used in accounting for the contract until the results can be estimated more precisely.

c. However, in some circumstances, estimating the final outcome may be impractical except to assure that no loss will be incurred. In those circumstances, a contractor should use a zero estimate of profit; equal amounts of revenue and cost should be recognized until results can be estimated more precisely. A contractor should use this basis only if the bases in (*a*) or (*b*) are clearly not appropriate. In accordance with FASB ASC 605-35-25-69, a change from a zero estimate of profit to a more precise estimate should be accounted for as a change in an accounting estimate.

2.06 FASB ASC 605-35-25-61 provides that 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 for which reasonably dependable estimates cannot be made or for which inherent hazards make estimates doubtful. FASB ASC 605-35-50-3 indicates that such a departure from the basic policy should be disclosed.

Completed-Contract Method

2.07 According to FASB ASC 605-35-25-92, the completed-contract method may be used as an entity's basic accounting policy in circumstances in which financial position and results of operations would not vary materially from those resulting from use of the percentage-of-completion method (for example, in circumstances in which an entity has primarily short-term contracts). Additionally, as provided by FASB ASC 605-35-25-94, the use of the completed-contract method of accounting is preferable in circumstances in which estimates cannot meet the criteria for reasonable dependability discussed in paragraph 2.05 of this chapter or if inherent hazards would make otherwise reasonably dependable contract estimates doubtful, as discussed in paragraphs 65–66 of FASB ASC 605-35-25. Paragraphs 96–97 of FASB ASC 605-35-25 establish completion criteria for determining when a contract is substantially completed under the completed-contract method.

Determining the Profit Center

2.08 In accordance with FASB ASC 605-35-25-4, the basic presumption should be that each individual contract is presumed to be the profit center for

revenue recognition, cost accumulation, and income measurement unless that presumption can be overcome as a result of the contract or series of contracts meeting the conditions for combining or segmenting as described in paragraphs 5–14 of FASB ASC 605-35-25.

Measuring the Extent of Progress Toward Completion

2.09 As set forth in FASB ASC 605-35-25-70, the various approaches toward measuring progress on a contract can be grouped into input and output measures. Input measures are made in terms of efforts devoted to a contract. They include the methods based on costs (for example, the ratio of costs incurred to date to total estimated costs at completion) and on efforts expended (for example, the ratio of hours performed to date to estimated total hours at completion). Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added (that is, the contract value of total work performed to date). For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed. In other circumstances, progress may be measured, for example, on the basis of cubic yards of excavation for foundation contracts or on the basis of cubic yards of pavement laid for highway contracts. FASB ASC 605-35-25-79 notes that all these practices are intended to conform to the income recognition provisions under the percentage-of-completion method discussed in paragraphs 51–53 in FASB ASC 605-35-25.

2.10 Both input and output measures require the exercise of judgment and careful application to circumstances. FASB ASC 605-35-25-78 states that the acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be reviewed and confirmed periodically by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.

Income Determination—Revenue

2.11 As set forth in FASB ASC 605-35-25-15, estimating the revenue on a contract is an involved process that is affected by a variety of uncertainties that depend on the outcome of a series of future events. The estimates must be periodically revised throughout the life of the contract as events occur and as uncertainties are resolved. The major factors that must be considered in determining total estimated revenue include (*a*) the basic contract price, (*b*) contract options, (*c*) change orders, (*d*) claims, and (*e*) contract provisions for penalty and incentive payments, including award fees and performance incentives.

Income Determination—Cost Elements

2.12 Paragraphs 32–33 of FASB ASC 605-35-25 establish that contract costs should be identified, estimated, and accumulated with a reasonable degree of accuracy in determining income earned. Moreover, an entity should be able to determine costs incurred on a contract with a relatively high degree of precision, depending on the adequacy and effectiveness of its cost accounting system.

The procedures or systems used in accounting for costs vary from relatively simple, manual procedures that produce relatively modest amounts of detailed analysis to sophisticated, computer-based systems that produce a great deal of detailed analysis. Despite the diversity of systems and procedures, however, an objective of each system or of each set of procedures should be to accumulate costs properly and consistently by contract with a sufficient degree of accuracy to ensure a basis for the satisfactory measurement of earnings.

Accounting for Contract Costs

2.13 The general principles applicable to the accounting for costs of construction-type contracts covered by FASB ASC 605-35 require the exercise of judgment and consist of the following, as directed in FASB ASC 605-35-25-37:

a. All direct costs, such as material, labor, and subcontracting costs, should be included in contract costs.

b. Indirect costs allocable to contracts include the costs of indirect labor, contract supervision, tools and equipment, supplies, quality control and inspection, insurance, repairs and maintenance, depreciation and amortization, and, in some circumstances, support costs such as central preparation and processing of payrolls. However, practice varies for certain types of indirect costs considered allocable to contracts (for example, support costs such as central preparation and processing of job payrolls, billing and collection costs, and bidding and estimating costs) as discussed in FASB ASC 605-35-25-34. For government contractors, in accordance with FASB ASC 912-20-25-1, indirect costs that are allowable or allocable under pertinent government contract regulations may be allocated to federal government contracts as indirect costs if otherwise allowable under generally accepted accounting principles (GAAP) of the United States. Methods of allocating indirect costs should be systematic and rational. They include, for example, allocations based on direct labor costs, direct labor hours, or a combination of direct labor and material costs. The appropriateness of allocations of indirect costs and of the methods of allocation depends on the circumstances and involves judgment.

c. Costs should be considered period costs if they cannot be clearly related to production, either directly or by an allocation based on their discernible future benefits in accordance with FASB ASC 605-35-25-35.

d. General and administrative costs ordinarily should be charged to expense as incurred but may be accounted for as contract costs under the completed-contract method of accounting, as discussed in FASB ASC 605-35-25-99.

e. Selling costs should be excluded from contract costs and charged to expense as incurred unless they meet the criteria for precontract costs in FASB ASC 605-35-25-41.

f. Costs under cost-type contracts should be charged to contract costs in conformity with U.S. GAAP in the same manner as costs under other types of contracts because unrealistic profit margins may result in circumstances in which reimbursable cost accumulations omit substantial contract costs (with a resulting larger fee) or

include substantial unallocable general and administrative costs (with a resulting smaller fee).

g. In computing estimated gross profit or providing for losses on contracts, estimates of cost to complete should reflect all of the types of costs included in contract costs.

h. Inventoriable costs should not be carried at amounts that, when added to the estimated cost to complete, are greater than the estimated realizable value of the related contracts.

Precontract Costs

2.14 The following provisions of FASB ASC 605-35-25-41 apply to precontract costs:

a. Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained should not be included in contract costs or inventory before the receipt of the contract. However, such costs otherwise may be deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from the contract is probable. Precontract costs that are start-up activities should be expensed as incurred if they are determined to be within the scope of FASB ASC 720-15.

b. Costs incurred for assets, such as costs for the purchase of materials, production equipment, or supplies, that are expected to be used in connection with anticipated contracts may be deferred outside the contract cost or inventory classification if their recovery from future contract revenue or from other dispositions of the assets is probable.

c. Costs incurred to acquire or produce goods in excess of the amounts required for an existing contract in anticipation of future orders for the same items may be treated as inventory if their recovery is probable.

d. Learning or start-up costs incurred in connection with existing contracts and in anticipation of follow-on or future contracts for the same goods or services should be charged to existing contracts.

e. Costs appropriately deferred in anticipation of a contract should be included in contract costs on the receipt of the anticipated contract.

f. Costs related to anticipated contracts that are charged to expenses as incurred because their recovery is not considered probable should not be reinstated by a credit to income on the subsequent receipt of the contract.

Cost Adjustments for Back Charges

2.15 As explained in FASB ASC 605-35-25-42, back charges are billings for 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. These are frequently disputed charges. For example, owners bill back charges to general contractors, and general contractors bill back charges to subcontractors. Examples of back charges include charges for cleanup work and charges for a subcontractor's use of a general contractor's equipment.

2.16 FASB ASC 605-35-25-43 provides the following guidance on accounting for back charges:

- Back charges to others should be recorded as receivables and, to the extent considered collectible, should be applied to reduce contract costs. However, if the billed party disputes the propriety or amount of the charge, the back charge is, in effect, a claim, and the criteria for recording claims apply. See paragraphs 30–31 of FASB ASC 605-35-25 for additional guidance on the accounting treatment of claims.
- Back charges from others should be recorded as payables and as additional contract costs to the extent that it is probable that the amounts will be paid.

Estimated Cost to Complete

2.17 The estimated cost to complete is a significant variable in the process of determining income earned and is thus a significant factor in accounting for contracts. According to FASB ASC 605-35-25-44, the following approaches should be followed in determining and updating the estimated cost to complete:

a. Systematic and consistent procedures that are correlated with the cost accounting system should be used to provide a basis for periodically comparing actual and estimated costs.

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

c. The estimating procedures should provide 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, especially when the contract performance will be carried out over a significant period of time. Escalation provisions should not be blanket overall provisions but should cover labor, materials, and indirect costs based on percentages or amounts that take into consideration experience and other pertinent data.

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

Computation of Earned Income

2.18 Paragraphs 82–84 of FASB ASC 605-35-25 and appendix B in this guide set forth and illustrate procedures for determining earned income for a period under the percentage-of-completion method.

Revised Estimates

2.19 FASB ASC 605-35-25-86 establishes that revisions in revenue, cost and profit estimates, or measurements of the extent of progress toward completion are changes in accounting estimates as defined FASB ASC 250, *Accounting Changes and Error Corrections*. Refer to paragraph 6.27 in this guide for additional discussion of revised estimates.

Provisions for Anticipated Losses on Contracts

2.20 The provision for loss arises because estimated cost for the contract exceeds estimated revenue. The following summarizes the accounting treatment of anticipated losses on contracts contained in paragraphs 45–50 of FASB ASC 605-35-25 and paragraphs 1–2 of FASB ASC 605-35-45:

- For contracts on which a loss is anticipated, the entire anticipated loss should be recognized in the period in which the loss becomes evident under either the percentage-of-completion method or the completed-contract method.
- The costs used in arriving at the estimated loss on a contract should include all costs of the type allocable to contracts under FASB ASC 605-35-25-37. Other factors that should be considered in arriving at the projected loss on a contract include (*a*) target penalties and interest, (*b*) nonreimbursable costs on cost-plus contracts, (*c*) change orders, and (*d*) potential price redeterminations.
- Provisions for losses should be shown separately as liabilities on the balance sheet, if significant, except in circumstances in which related costs are accumulated on the balance sheet, in which case the provisions may be deducted from the related accumulated costs. In a classified balance sheet, a provision for loss should be shown as a current liability.
- The provision for loss should be accounted for in the income statement as an additional contract cost rather than as a reduction of contract revenue. Unless the provision is material in amount or unusual or infrequent in nature, the provision should be included in contract cost and should not be shown separately in the income statement. If it is shown separately, it should be shown as a component of the cost included in the computation of gross profit.

Selecting a Measure of Extent of Progress

2.21 A good measure of extent of progress toward completion should give weight to all elements of a contractor's work and should consider the broad phases of a contractor's operation, such as

- designing the project (preparing blueprints to meet the owner's specifications).
- obtaining the necessary labor, materials, supplies, and equipment and mobilizing them at the construction site. Refer to FASB ASC 605-35-25-76 for a discussion of uninstalled materials as they relate to measuring the extent of progress using an input measure based on costs (for example, the ratio of costs incurred to date to total estimated costs at completion).
- managing the resources to complete the project.
- demobilizing the resources from the construction site.

Costs of Equipment and Small Tools

2.22 The cost of a contractor's equipment should be allocated to the particular contract on which it is used on a reasonable basis, such as time, hours

of use, or mileage. Based on the reported use of the equipment, a rate may be arrived at that will serve as a basis for charging the contracts on which the equipment is used. In determining the operating unit costs for construction equipment to be included in contract cost, paragraphs 1–2 of FASB ASC 910-20-25 and FASB ASC 910-20-30-1 establish that contractors may utilize the use rate theory. In applying this theory, the following factors should be considered: (*a*) the cost of the equipment, less estimates of its salvage value or rental if it is leased, (*b*) the probable life of the equipment, (*c*) the average idle time during the life or period of hire of the equipment, and (*d*) the costs of operating the equipment, such as repairs, storage, insurance, and taxes.

2.23 In determining a suitable indirect cost allocation method for equipment, questions arise relating to accounting for equipment charges when a contractor's equipment is idle during a winter season or related to the propriety of allocating idle equipment costs to jobs. FASB ASC 910-20-25-3 states that idle equipment time, such as when a contractor's equipment is idle during a winter season, may be considered in determining indirect cost allocations. Allocation of idle equipment costs to contracts by use of rates geared to cover all costs is appropriate. That procedure results in rates that lessors of the same type of equipment charge users in the same location, except for the profit element.

2.24 FASB ASC 910-20-25-4 states that small tools should be charged to a contract as they are consumed in performance of the contract. Operating and maintenance costs of miscellaneous small tools and equipment are usually charged to overhead accounts rather than specific contracts. However, a contractor may charge the costs directly to specific contracts if they relate to specific contracts. Small tools can frequently be charged to contracts if purchased for the contracts or if issued from a central pool. Contract costs should be credited with estimated salvage value of small tools remaining at completion of the contracts.

2.25 If small tools are significant, they may be accounted for as inventory or fixed assets. FASB ASC 910-330-40-1 states that removals of small tools from inventory may be charged to specific contracts or charged to overhead and spread over jobs on an equitable basis. FASB ASC 910-360-35-1 states that depreciation of small tools carried in fixed assets may be charged to overhead or to specific contracts.

Chapter 3

Accounting for and Reporting Investments in Construction Joint Ventures

3.01 As noted in chapter 1, "Industry Background," contractors frequently participate in construction joint ventures with other parties to share risks, combine financial and other resources, or obtain financing or bonding. The Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary defines a *joint venture* as an entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complimentary technological knowledge; or to pool resources in developing production or other facilities. Commonly, a joint venture or arrangement will involve the combination of a nonlocal entity having a customer relationship or expertise with a local contractor who is qualified to construct the project and has labor in the local market. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers, thus, have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.

3.02 Entities described as construction joint ventures vary in their legal forms. They include corporations, general and limited partnerships, limited liability companies, and undivided interests. The entities, which are usually project oriented, are often viewed as joint ventures even though one of the investors may have a majority voting interest or may otherwise have effective control of the entity. Because this chapter presents guidance on accounting for investments in entities described as construction joint ventures, questions relating to the existence of control are also addressed.

Joint Venture Accounting

Accounting Methods

3.03 According to FASB ASC 323-10-05-4, investments in the stock of entities other than subsidiaries, namely corporate joint ventures and other noncontrolled entities, usually are accounted for using either the equity method, the cost method, or the fair value method. As explained in FASB ASC 323-10-15-3, the guidance in FASB ASC 323, *Investments—Equity Method and Joint Ventures*, applies to investments in 50 percent or less of the common stock or in-substance common stock (or both common stock and in-substance common stock). The FASB ASC glossary defines *in-substance common stock* as an investment in an entity that has risk and reward characteristics that are substantially similar to that entity's common stock.

3.04 FASB ASC 323-10-05-5 establishes that the equity method tends to be the most appropriate if an investment enables the investor to influence the

operating or financial decisions of the investee. As further explained in FASB ASC 323-10-15-8, an investment (direct or indirect) of 20 percent or more of the voting stock of an investee creates the presumption that in the absence of predominant evidence to the contrary, an investor has the ability to exercise significant influence over an investee. Conversely, an investment of less than 20 percent of the voting stock of an investee creates the presumption that an investor does not have the ability to exercise significant influence unless such ability can be demonstrated. Determining the ability of an investor to exercise significant influence is not always clear, and applying judgment is necessary to assess the status of each investment. Paragraphs 6–11 of FASB ASC 323-10-15 define *significant influence*.

3.05 FASB ASC 323-10-25-2 cautions that the equity method is not a valid substitute for consolidation. *Consolidation* is defined by the FASB ASC glossary as the presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intraentity transactions and balances. FASB ASC 323-10-25-2 also cautions that there are certain other limitations to the use of the equity method identified in paragraphs 8 and 10 of FASB ASC 810-10-15 including, but not limited to, circumstances in which the relevant provisions applicable to variable interest entities (VIEs) in FASB ASC 810, *Consolidation*, apply.

3.06 FASB ASC 325-20-35-3 explains that investments in joint ventures of less than 20 percent of the voting stock are presumed to indicate an investor's inability to exercise significant influence in the absence of predominant evidence to the contrary, in which case the use of the cost method is generally followed. FASB ASC 323-10-15-9 clarifies that an investor's voting stock interest in an investee should be based on those currently outstanding securities whose holders have present voting privileges. Potential voting privileges that may become available to holders of securities of an investee should be disregarded.

3.07 The fair value method of accounting for equity investments is normally not applicable to investments in joint ventures because it requires the availability of readily determinable fair values for the equity securities as noted in FASB ASC 320-10-15-5, and it is not available if the investments otherwise meet the criteria for the use of the cost method or equity method as noted in FASB ASC 320-10-15-7.

Capital Contributions to Joint Ventures and Initial Measurement of Investments in Joint Ventures

3.08 "Pending Content" in FASB ASC 323-10-30-2 explains that, under the equity method, an investor should recognize an investment in a joint venture initially at cost, in accordance with FASB ASC 805-50-30. However, an investor should initially measure, at fair value, a retained investment in the common stock of an investee (including a joint venture) in a deconsolidation transaction in accordance with "Pending Content" in paragraphs 3A–5 of FASB ASC 810-10-40. However, FASB ASC 325-20-30-1 explains that under the cost method, an investee will recognize a similar investment in the stock of an investee as an asset measured initially at cost.

3.09 Cash capital contributions to a venture by a venturer should be recorded by the venturer as an investment in the amount of the cash contributed. As a general rule, the contribution of other assets should be recorded as an investment equal to the contributed asset's net book value on the venturer's

books. That basis should be used regardless of the nature of the interest in the venture obtained from the transaction.

3.10 "Pending Content" in FASB ASC 845-10-15-4 clarifies that the guidance in FASB ASC 845, *Nonmonetary Transactions*, does not apply to a transfer of nonmonetary assets solely between a corporate joint venture and its owners, nor does it apply to a transfer of assets to an entity in exchange for an equity interest in that entity, including the exchange of a nonfinancial asset for a noncontrolling ownership interest in a joint venture. Moreover, FASB ASC 845-10-15-14 clarifies that the guidance in FASB ASC 845 pertaining to nonmonetary exchanges involving monetary consideration (referred to as *boot*) does not apply to transfers between a joint venture and its owners. Note that the FASB ASC glossary defines *nonmonetary assets and liabilities* as assets and liabilities other than monetary ones and *monetary assets and liabilities* as assets and liabilities whose amounts are fixed in terms of units of currency by contract or otherwise. Additionally, the FASB ASC glossary defines an *exchange* (or *exchange transaction*) as a reciprocal transfer between two entities that results in one of the entity's acquiring assets or services or satisfying liabilities by surrendering other assets or services or incurring other obligations.

3.11 A noncash contribution may be accompanied by a cash withdrawal by the contributing venturer. The receipt of cash may represent monetary consideration on which the venturer should recognize profit to the extent of the other venturers' proportionate interests.

3.12 The following illustrates a transaction in which the contributing venturer should recognize profit:

> A and B are to share equally in a new joint venture. A contributes $100,000 in cash, and B contributes equipment with carrying value to him of $140,000. To equalize the contributions, A and B agree that B will withdraw $100,000 from the venture. The conditions required for proportionate profit recognition by B are present.
>
> *Results*
>
> 1. The transaction indicates that the equipment has a fair value of $200,000.
> 2. B now effectively owns a 50 percent interest in the equipment.
> 3. B, therefore, has effectively sold a 50 percent interest in the equipment to A for $100,000 and should recognize a gain before income taxes of $30,000, that is, $100,000 – (1/2 × $140,000).
> 4. B should recognize an additional $30,000 as a gain as the venture depreciates the equipment. The venture would initially record the equipment on its books at its indicated fair value of $200,000.

3.13 A venturer may contribute assets to a venture and obtain an interest in the venture smaller than the carrying amount of contributed assets, based on the relationship of the carrying amount of the asset to the cash contributed by the other venturers. In those circumstances, the transaction might provide evidence that the cost or carrying amount of the contributed assets is greater than their fair value, and that a loss should be recognized. Under the general principle that all losses should be recognized when they become evident, an

indicated loss should be recognized by the venturer, with a corresponding reduction in the carrying amount of its investment in the venture. In measuring fair value, refer to the discussion in chapter 2, "Accounting for Performance of Construction-Type Contracts."

3.14 The following is an illustration of a transaction in which a venturer should recognize a loss:

> A and B are to share equally in a new joint venture. A contributes $100,000 in cash, and B contributes equipment with a carrying value to him of $140,000.
>
> *Results*
>
> 1. The transaction indicates that the equipment has a fair value of $100,000 (the amount of A's contribution).
> 2. B should recognize a loss of $40,000 and record its investment in the venture at $100,000.

3.15 A venturer may obtain an interest in a venture by contributing service or "know-how." If the services are to be provided in the future, the cost should not be assigned to the investment account until the services are performed. Recognition of the venturer's share of the profits on withdrawals received before the performance of the services should be deferred until the services are performed and the earning process is complete.

Sales to a Venture

3.16 Sales of materials, supplies, or services to a venture by a venturer that controls the venture, through majority voting interest or otherwise, generally should not be viewed as arm's length transactions. The venturer should not recognize as income any of the intercompany profit or loss from such transactions until it has been realized through transactions with outside third parties.

3.17 FASB ASC 323-10-35-10 states that when an investor controls an investee through majority voting interest and enters into a transaction with an investee that is not on at arm's length, none of the intraentity profit or loss from the transaction should be recognized in income by the investor until it has been realized through transactions with third parties. The same treatment also applies for an investee established with the cooperation of an investor (including an investee established for the financing and operation or leasing of property sold to the investee by the investor) if control is exercised through guarantees of indebtedness,[1] extension of credit and other special arrangements by the investor for the benefit of the investee, or because of ownership by the investor of warrants, convertible securities, and so forth issued by the investee.

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[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 460-10-50-6 states that some guarantees are issued to benefit entities that are related parties such as joint ventures, equity method investees, and certain entities for which the controlling financial interest cannot be assessed by analyzing voting interests. In those cases, the disclosures required by FASB ASC 460, *Guarantees*, are incremental to the disclosures required by FASB ASC 850, *Related Party Disclosures*. FASB ASC 460-10-25-4 clarifies that a guarantor should recognize in its statement of financial position, at the inception of a guarantee, a liability for that guarantee. The offsetting entry depends on the circumstances in which the guarantee was issued. Among other circumstances described in FASB ASC 460-10-55-23, a guarantee issued in conjunction with the formation of a partially owned business or a venture accounted for under the equity method results in an increase to the carrying amount of the investment. "Pending Content" in FASB ASC 460-10-25-1 clarifies a guarantee issued either between parents and their subsidiaries or between corporations under common control are not subject to the recognition provisions of FASB ASC 460.

3.18 However, a transaction may be deemed to be on an arm's length basis, which means that is the price that would be received to sell the property in an orderly transaction between market participants who are independent of the reporting entity. A controlling venturer may recognize profit to the extent of other interests in the venture if the following conditions are met:

- The transaction was entered into at a price determinable on an arm's length basis; that is, fair value can be measured by comparable sales at normal selling prices to independent third parties or by competitive bids. As provided by FASB ASC 820-10-35-3, the objective of a fair value measurement is to determine the price that would be received to sell the asset (or paid to transfer the liability) at the measurement date (an exit price). A fair value measurement assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date. The FASB ASC glossary defines *market participants* as buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:
    - — Independent of the reporting entity (that is, they are not related parties)
    - — Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary
    - — Able to transact for the asset or liability
    - — Willing to transact for the asset or liability (that is, they are motivated but not forced or otherwise compelled to do so)
- No substantial uncertainties exist regarding the venturer's ability to perform, such as those that may be present if the venturer lacks experience in the business of the venture or regarding the total cost of the services to be rendered.
- The venture is creditworthy and has independent financial substance.

3.19 A venturer that does not control the venture should recognize intercompany profit to the extent of other interests in the venture.

Subsequent Measurement and Presentation of Investments in Joint Ventures

3.20 At least five different methods of presenting a venturer's interest in a venture are followed in present practice:

- *Consolidation.* The venture is fully consolidated, with the other venturers' interests shown as noncontrolling interests.
- *Partial or proportionate consolidation.* The venturer records its proportionate interest in the venture's assets, liabilities, revenues, and expenses on a line-by-line basis and combines the amounts directly with its own assets, liabilities, revenues, and expenses

without distinguishing between the amounts related to the venture and those held directly by the venturer. Paragraph 14 of FASB ASC 810-10-45 provides that an investee in the construction industry may present its investment in an unincorporated legal entity accounted for by the equity method using the proportionate gross financial statement presentation.

- *Expanded equity method.* The venturer presents its proportionate share of the venture's assets and liabilities in capsule form, segregated between current and noncurrent. The elements of the investment are presented separately by including the venturer's equity in the venture's corresponding items under current assets, current liabilities, noncurrent assets, noncurrent liabilities, revenues, and expenses, using a caption such as "investor's share of net current assets of joint ventures."
- *Equity method.* Paragraphs 1–2 of FASB ASC 323-10-45 establish that an investment accounted for under the equity method of accounting should be shown in the balance sheet of an investor as a single amount. Likewise, an investor's share of earnings or losses from its investment shall be shown in its income statement as a single amount, except for an investor's share of extraordinary items and its share of accounting changes reported in the financial statements of the investee, which should be classified separately in accordance with FASB ASC 225-20. An investor should recognize its share of the earnings or losses of an investee based on the shares of common stock and in-substance common stock held by that investor, as set forth in FASB ASC 323-10-35-4, in the periods for which they are reported by the investee in its financial statements. An investor should adjust the carrying amount of an investment for its share of the earnings or losses of the investee after the date of investment and shall report the recognized earnings or losses in income.[2] Paragraphs 31–32 of FASB ASC 323-10-35 explain that a loss in value of an equity method investment that is other than a temporary decline should be recognized even though the decrease in value is in excess of what would otherwise be recognized by application of the equity method. A series of operating losses of an investee or other factors may indicate that an other than temporary decrease in value of the investment has occurred. FASB ASC 323-10-35-32A states that an equity method investor should not separately test an investee's underlying asset(s) for impairment. However, an equity investor should recognize its share of any impairment charge recorded by an investee in accordance with the guidance in FASB ASC 323-10-35-13 and FASB ASC 323-10-45-1 and consider the effect, if any, of the impairment on the investor's basis difference in the assets giving rise to the investee's impairment charge.
- *Cost method.* As provided in FASB ASC 325-20-35-1, under the cost method of accounting for investments in common stock,

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[2] Paragraphs 37–39 of FASB ASC 323-10-35 address how an investor should account for its proportionate share of an investee's equity adjustments for other comprehensive income upon a loss of significant influence, a loss of control that results in the retention of a cost method investment, and discontinuation of the equity method for an investment in a limited partnership because the conditions in FASB ASC 970-323-25-6 are met for applying the cost method.

dividends are the basis for recognition by an investor of earnings from an investment. An investor recognizes as income dividends received that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. The net accumulated earnings of an investee subsequent to the date of investment are recognized by the investor only to the extent distributed by the investee as dividends. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment. As with equity method investments, FASB ASC 325-20-35-2 explains that a loss in value of a cost method investment that is other than a temporary decline should be recognized. A series of operating losses of an investee or other factors may indicate that a decrease in value of the investment has occurred that is other than temporary.

3.21 The extent of the use of those methods varies; however, they have all been used in, or have been considered acceptable for use in, accounting for investments in joint ventures in the construction industry. Combinations of those methods have also been used in the construction industry. For example, a common combination is to use the one-line equity method in the balance sheet and the proportionate consolidation method in the income statement.

Corporate Joint Ventures

3.22 Paragraph 3 of FASB ASC 323-10-15 establishes that the equity method of accounting applies to investments in the common stock of corporate joint ventures. FASB ASC 323-10 provides guidance and establishes requirements on the application of the equity method. According to FASB ASC 323-10-05-4, the equity method of accounting more closely meets the objectives of accrual accounting than does the cost method because the investor recognizes its share of the earnings and losses of the investee in the periods in which they are reflected in the accounts of the investee. The equity method also best enables investors in corporate joint ventures to reflect the underlying nature of their investment in those ventures.[3]

3.23 In its definition of a *corporate joint venture*, the FASB ASC glossary explains an entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. A *subsidiary*, according to "Pending Content" in the FASB ASC glossary, is an entity, including an unincorporated entity, such as a partnership or trust, in which another entity, known as its *parent*, holds a controlling financial interest, including a VIE that is consolidated by a primary beneficiary.

3.24 A controlling venturer, in accordance with FASB ASC 810-10-15-10, should consolidate all majority-owned subsidiaries (that is, all entities in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) that are not VIEs within the scope of the

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[3] FASB ASC 810-10-45-13 establishes that a parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*. This issue does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

applicable subsections in FASB ASC 810-10 related to VIEs. Other exceptions to the guidance in FASB ASC 810 are provided in "Pending Content" in FASB ASC 810-10-15-12.

Variable Interest Entities

3.25 FASB ASC 810-10 provides guidance and establishes requirements pertaining to the consolidation of VIEs, defined by the FASB ASC glossary as entities subject to consolidation according to the applicable subsections in FASB ASC 810-10 related to VIEs. This FASB ASC subtopic explains how to apply the consolidation guidance of FASB ASC 810 to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The FASB ASC glossary term *subordinated financial support* is defined as variable interests that will absorb some or all of a VIE's expected losses. "Pending Content" in FASB ASC 810-10-15-14 states that an entity should follow the consolidation guidance for VIEs in FASB ASC 810-10 if, by design, any of the following conditions exist:

a. The total equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders.

b. As a group, the holders of the equity investment at risk lack any one of the following three characteristics:

   i. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly affect the entity's economic performance[4]

   ii. The obligation to absorb the expected losses of the legal entity

   iii. The right to receive the expected residual returns of the legal entity

c. The equity investors as a group otherwise lack the characteristic noted in the preceding item (b)(i) as a result of both of the following conditions being present:

   i. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.

   ii. Substantially all of the legal entity's activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights.

3.26 FASB ASC 810-10 may affect the way construction contractors account for and report their investments in construction joint ventures. As

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[4] Among other significant provisions, "Pending Content" in FASB ASC 810-10-15-14 notes that kick-out rights or participating rights held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights should not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights.

provided in "Pending Content" in FASB ASC 810-10-25-38, an entity shall consolidate a VIE when that reporting entity has a variable interest (or combination of variable interests) that provide the entity with a controlling financial interest on the basis of the provisions of "Pending Content" in paragraphs 38A–38G of FASB ASC 810-10-25, as discussed in paragraphs 3.27–.28. The entity that consolidates a VIE is called the primary beneficiary of that VIE. A *primary beneficiary*, according to "Pending Content" in the FASB ASC glossary, in an entity that consolidates a VIE.

3.27 "Pending Content" in FASB ASC 810-10-25-38A states that an entity with a variable interest in a VIE should assess whether it has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. The entity is deemed to have a controlling interest if it has both of the following characteristics:

- The power to direct the activities of the VIE that most significantly affect the VIE's economic performance
- The obligation to absorb the 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[5]

Only one reporting entity is expected to be identitfied as the primary beneficiary of a VIE, although several may have the characteristics of second item in he preceding list.[6] Only one entity will have the power to direct the activities of the VIE that most significantly affect the VIE's economic performance.

3.28 "Pending Content" in FASB ASC 810-10-25-38B states that an entity is not required to exercise the power it holds over a VIE, as established in paragraph 3.27, in order to have power to direct the activities of a VIE.

3.29 "Pending Content" in FASB ASC 810-10-30-8 clarifies that the initial measurement by the consolidating entity of the assets, liabilities, and noncontrolling interests of the VIE at the date the requirements of the VIE subsections in FASB ASC 810-10 first apply depends on whether the determination of their carrying amounts is practical. In this context, *carrying amounts* refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the VIE subsections had been effective when the entity first met the conditions to be the primary beneficiary.

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[5] The use of a quantitative approach, as discussed in the FASB ASC glossary definitions of *expected losses*, *expected residual returns*, and *expected variability* is not required and should not be the sole determinant about whether the entity has those obligations or rights.

[6] If the entity determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of the variable interest entity (VIE) that most significantly affect the VIE's economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly affect the VIE's economic performance and if decisions about those activities require the consent of each of the parties sharing power. If the entity concludes that power is not shared, but the activities that most significantly affect the VIE's economic performance are directed by multiple unrelated parties, and the nature of activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities will be considered to have the characteristics in the first item in the bulleted list in paragraph 3.27.

However, if the activities that affect the VIE's economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then the entity should identify which party has the power to direct the activities that most significantly affect the VIE's economic performance. Only one party will have this power.

3.30 If determining the carrying amounts is practicable, the consolidating entity should initially measure the assets, liabilities, and noncontrolling interests of the VIE at their carrying amounts at the date the VIE subsections first apply.

3.31 If determining the carrying amounts is not practicable, the consolidating entity should initially measure the assets, liabilities, and noncontrolling interests of the VIE at their fair value at the date the VIE subsections first apply. As an alternative to this fair value measurement requirement, the assets and liabilities of the VIE may be measured at their unpaid principal balances at this same date, if both of the following conditions are met:

- The activities of the VIE are primarily related to securitizations or other forms of asset-backed financing.
- The assets of the VIE can be used only to settle obligations of the entity.

This measurement alternative does not obviate the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses, or other-than-temporary impairment, as appropriate. Other assets, liabilities, or noncontrolling interests, if any, that do not have an unpaid principal balance and any items that are required to be carried at fair value under other applicable standards should be measured at fair value.

3.32 Any difference between the net amount added to the balance sheet of the consolidating entity and the amount of any previously recognized interest in the newly consolidated VIE would be recognized as a cumulative effect of an accounting change.

3.33 In accordance with FASB ASC 810-10-35-3, after the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE should be accounted for in consolidated financial statements as if the VIE were consolidated based upon voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates should be applied as they would be applied to a consolidated subsidiary. The consolidated entity should follow the requirements for elimination of intraentity balances and transactions and other matters described in FASB ASC 810-10-45, FASB ASC 810-10-50-1, and "Pending Content" in FASB ASC 810-10-50-1B, as well as existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE should be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE should be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

3.34 In accordance with "Pending Content" in FASB ASC 810-10-45-16, the noncontrolling interest should be reported in the consolidated statement of financial position within equity (net assets), separately from the parent's equity (or net assets). The amount should be clearly identified and labeled, for example, as noncontrolling interest in subsidiaries. An entity with noncontrolling interests in more than one subsidiary may present those interests in aggregate in the consolidated financial statements.

General Partnerships

3.35 FASB ASC 323-30-25-1 states that investors in unincorporated entities, such as partnerships, generally should account for their investments using

the equity method of accounting by analogy to FASB ASC 323-10 if the investor has the ability to exercise significant influence over the investee.

3.36 The principal difference, aside from income tax considerations, between corporate joint ventures and general partnerships is that a condition that would usually indicate control of a general partnership is ownership of a majority (over 50 percent) of the financial interests in profits or losses. The power to control a general partnership may also exist with a lesser percentage of ownership, for example, by contract, by agreement with other partners, or by court decree. On the other hand, majority ownership may not constitute control if major decisions such as the acquisition, sale, or refinancing of principal partnership assets must be approved by one or more of the other partners.

Limited Partnerships

3.37 FASB ASC 810-10-15-10(b) states that FASB ASC 810-20, which discusses control of partnerships, should be applied to determine whether the rights of the limited partners in a limited partnership overcome the presumption that the general partner controls, and therefore should consolidate, the partnership. According to FASB ASC 810-20-15-3, the guidance in FASB ASC 810-20 does not apply to the following entities:

- Limited partnerships or similar entities (such as limited liability companies that have governing provisions that are the functional equivalent of a limited partnership) that are entities within the scope of the VIE subsections of FASB ASC 810-10
- A general partner that, in accordance with generally accepted accounting principles (GAAP) of the United States, carries its investment in the limited partnership at fair value with changes in fair value reported in a statement of operations or financial performance
- Entities in industries in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership as provided in FASB ASC 810-10-45-14
- Circumstances in which no single general partner in a group of general partners controls the limited partnership

3.38 The accounting recommendations for investments in general partnerships are generally appropriate for accounting by limited partners for their investments in limited partnerships. However, a limited partner's interest may be so minor that the investor may have virtually no influence over partnership operating and financial policies.[7] Such a limited partner is, in substance, in the same position relative to the investment as an investor that owns a minor common stock interest in a corporation, and, accordingly, accounting for the investment using the cost method may be appropriate.

3.39 Paragraphs 1–3 of FASB ASC 810-20-25 clarify that the determination of which, if any, general partner within the group controls and, therefore, shall consolidate the limited partnership is based on an analysis of the relevant

[7] FASB ASC 323-30-S99-1 states that the Securities and Exchange Commission (SEC) staff's position on all investments in limited partnerships is that these investments should be accounted for using the equity method unless the investor's interest "is so minor that the limited partner may have virtually no influence over partnership operating and financial policies." The SEC staff understands that practice generally has viewed investments of more than 3 percent to 5 percent to be more than minor.

facts and circumstances. In situations involving multiple general partners, entities under common control are considered to be a single general partner for purposes of applying the guidance in FASB ASC 810-20. The general partners in a limited partnership are presumed to control that limited partnership regardless of the extent of the general partners' ownership interest in the limited partnership.

3.40 However, if the substance of the partnership arrangement is such that the general partners are not in control of the partnership's major operating and financial policies, a limited partner may be in control. An example could be a limited partner holding over 50 percent of the total partnership interest.

3.41 As provided in FASB ASC 810-10-15-10, the guidance in FASB ASC 810-20 should be applied to determine whether the rights of the limited partners in a limited partnership overcome the presumption that the general partner controls, and therefore should consolidate, the partnership. If, based on the criteria set forth in FASB ASC 810-20, presumption of control by the general partners can be overcome, then each of the general partners would account for its investment in the limited partnership using the equity method of accounting.[8]

Undivided Interests in Ventures

3.42 FASB ASC 323-30-15-3 clarifies that investments in partnerships and unincorporated joint ventures may also be called *undivided interests in ventures*. According to FASB ASC 810-10-45-14, if the investor-venturer owns an undivided interest in each asset and is proportionately liable for its share of each liability, the provisions of FASB ASC 323-10-45-1 relating to the application of the equity method of accounting may not apply to investees in the construction industry. For example, proportionate consolidation using a proportionate gross financial statement presentation wherein the investor-venturer accounts in its financial statements for its pro rata share of the assets, liabilities, revenues, and expenses of the venture may be appropriate.

Determining Venturers' Percentage Ownership

3.43 Many joint venture agreements designate different allocations among the venturers of (*a*) the profits and losses, (*b*) the specified costs and expenses or revenues, (*c*) the distributions of cash from operations, and (*d*) the distributions of cash proceeds from liquidation. Such agreements may also provide for changes in the allocations at specified future dates or on the occurrence of specified future events. For the purpose of determining the amount of income or loss to be recognized by the venturer, the percentage of ownership interest should be based on the percentage by which costs and profits will ultimately be shared by the venturers. An exception to this general rule may be appropriate

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[8] Paragraphs 4–20 of FASB ASC 810-20-25 establish certain rights held by limited partner(s) that would overcome the presumption of control by the general partners. The assessment of whether the rights of the limited partners shall overcome the presumption of control by the general partners is a matter of judgment that depends on facts and circumstances. The general partners do not control the limited partnership if the limited partners have (*a*) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause, (*b*) substantive participating rights, (*c*) substantive kick-out rights, and (*d*) protective rights that provide the limited partners with the right to effectively participate in significant decisions that would be expected to be made in the ordinary course of the limited partnership's business while being protective of the limited partners' investment. Refer to the FASB ASC glossary for definitions of the aforementioned terms and to FASB ASC paragraphs noted initially for further guidance.

if changes in the percentages are scheduled or expected to occur so far in the future that they become meaningless for current reporting purposes. In those circumstances, the percentage interest specified in the joint venture agreement should be used with appropriate disclosures.

Conforming the Accounting Principles of the Venture

3.44 The accounts of a venture may reflect accounting practices, such as those used to prepare tax basis data for investors, that vary from GAAP. If the financial statements of the investor are to be prepared in conformity with GAAP, such variances that are material should be identified and conformed to U.S. GAAP in applying the equity method.

Losses in Excess of a Venturer's Investment, Loans, and Advances

3.45 A venturer should record its share of joint venture losses in excess of its investment, loans, and advances in accordance with paragraphs 19–30 of FASB ASC 323-10-35. An investor's share of losses of an investee may equal or exceed the carrying amount of an investment accounted for by the equity method plus advances made by the investor. An equity method investor should continue to report losses up to the investor's investment carrying amount, including any additional financial support made or committed to by the investor. Additional financial support made or committed to by the investor may take the form of any of the following:

- Capital contributions to the investee
- Investments in additional common stock of the investee
- Investments in preferred stock of the investee
- Loans to the investee
- Investments in debt securities (including mandatorily redeemable preferred stock) of the investee
- Advances to the investee

The investor ordinarily should discontinue applying the equity method if the investment (and net advances) is reduced to zero and shall not provide for additional losses unless the investor has guaranteed obligations of the investee or is otherwise committed to provide further financial support for the investee. Such circumstances may be evidenced by

- legal obligation as a guarantor[9] or general partner.
- commitment based on such considerations as business reputation, intercompany relationships, and credit standing. Such a commitment might be evidenced by
  - — previous support by the venturer indicating that it would make good joint venture obligations.
  - — public statements by the venturer of its intention to provide support.

[9] See footnote 2.

An investor should, however, provide for additional losses if the imminent return to profitable operations by an investee appears to be assured. For example, a material, nonrecurring loss of an isolated nature may reduce an investment below zero even though the underlying profitable operating pattern of an investee is unimpaired. If the investee subsequently reports net income, the investor should resume applying the equity method only after its share of that net income equals the share of net losses not recognized during the period the equity method was suspended. For additional guidance, refer to FASB ASC 323-10.

Disclosures in a Venturer's Financial Statements

3.46 In addition to the presentation of the basic financial statements and required disclosures in those statements, paragraphs 1–3 of FASB ASC 323-10-50 describe additional disclosures relating to investments accounted for using the equity method of accounting. All of the following disclosure requirements generally apply to the equity method of accounting for investments in common stock:

- Financial statements of an investor should parenthetically disclose, in notes to financial statements or in separate statements or schedules
  - — the name of each investee and percentage of ownership of common stock.
  - — the accounting policies of the investor with respect to investments in common stock. Disclosure shall include the names of any significant investee entities in which the investor holds 20 percent or more of the voting stock, but the common stock is not accounted for on the equity method, together with the reasons why the equity method is not considered appropriate, and the names of any significant investee corporations in which the investor holds less than 20 percent of the voting stock and the common stock is accounted for on the equity method, together with the reasons why the equity method is considered appropriate.
  - — the difference, if any, between the amount at which an investment is carried and the amount of underlying equity in net assets and the accounting treatment of the difference.
- For those investments in common stock for which a quoted market price is available, the aggregate value of each identified investment based on the quoted market price usually shall be disclosed. This disclosure is not required for investments in common stock of subsidiaries.
- If investments in common stock of corporate joint ventures or other investments accounted for under the equity method are, in the aggregate, material in relation to the financial position or results of operations of an investor, it may be necessary for summarized information about assets, liabilities, and results of operations of the

investees to be presented in the notes or in separate statements, either individually or in groups, as appropriate.

- Conversion of outstanding convertible securities, exercise of outstanding options and warrants, and other contingent issuances of an investee may have a significant effect on an investor's share of reported earnings or losses. Accordingly, material effects of possible conversions, exercises, or contingent issuances shall be disclosed in notes to financial statements of an investor.

For disclosures related to consolidated financial statements and VIEs, readers should refer to the guidance in FASB ASC 810-10-50. When presenting financial statements that include cost-method investments, readers should refer to the guidance in FASB ASC 325-20-50.

3.47 Additional items that a venturer should consider for disclosure include

- any important provisions of the joint venture agreement.
- if the joint venture's financial statements are not fully consolidated with those of the venturer, separate or combined financial statements of the ventures in summary form, including disclosure of accounting principles of the ventures that differ significantly from those of the venturer.
- intercompany transactions during the period and the basis of intercompany billings and charges.
- liabilities and contingent liabilities arising from the joint venture arrangement, including venturer's obligations under guarantees.[10]

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[10] See footnote 2.

Chapter 4

Financial Reporting by Affiliated Entities

4.01 Nonaccounting considerations, including taxation and exposure to legal liability, dictate the organizational structure and operating arrangements of many entities in the construction industry. As a result, many construction operations, when viewed as economic units, include several affiliated entities that are *related parties*, which, as defined in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary, includes

- affiliates of the entity.
- entities for which investments in their equity securities would be required, absent the election of the fair value option in FASB ASC 825–10–15, to be accounted for by the equity method by the investing entity.
- trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management.
- principal owners of the entity and members of their immediate families.
- management of the entity and members of their immediate families.
- other parties with which the entity may enter into transactions if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.
- other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

An *affiliated entity*, as defined by the FASB ASC glossary, is an entity that directly or indirectly controls, is controlled by, or is under common control with another entity. The definition also includes a party with which the entity may deal if one party has the ability to exercise significant influence over the other's operating and financial policies. Paragraphs 6–11 of FASB ASC 323-10-15 define *significant influence*.

4.02 The owners of closely held construction contractors may establish separate legal entities to acquire equipment or real estate that are then leased to the contractor. The separate financial statements of the members of the group usually cannot stand on their own because they may not reflect appropriate contract revenue, costs, or overhead allocations and because transactions may be unduly influenced by controlling related parties. A presumption exists that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.

4.03 FASB ASC 810, *Consolidation*, provides guidance for determining whether and how to consolidate another entity and the basis of presentation. FASB ASC 810-10-10-1 states that the purpose of consolidated statements is to present, primarily for the benefit of the owners and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries essentially as if the consolidated group were a single economic entity. Among other types of investments by a reporting entity in an affiliated entity, FASB ASC 810 provides guidance and establishes requirements on the financial statement presentations of the following common types of investments that a reporting entity may have in another entity:

- Investments by a parent that constitute a controlling financial interest through direct or indirect ownership of a majority voting interest in a subsidiary
- Investments by a reporting entity in another entity that is not determined to be a variable interest entity (VIE) that constitute a controlling financial interest
- Investments by a reporting entity in another entity that is not determined to be a VIE that constitute a noncontrolling financial interest
- Investments by a reporting entity in a partnership or similar entity that is not determined to be a VIE
- Investments by a reporting entity in another entity that is determined to be a VIE[1]

Combined Financial Statements

4.04 For the purpose of presenting financial condition, results of operations, and cash flows of a group of commonly controlled entities that generally conduct their construction operations as, in effect, a single economic entity, FASB ASC 810-10-55-1B establishes that combined financial statements (as distinguished from consolidated financial statements) are likely to be more meaningful. The FASB ASC glossary defines *combined financial statements* as financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic unit. The combined group does not include the parent. Examples of circumstances in which combined financial statements may be useful, as provided in FASB ASC 810-10-55-1B, include the existence of several entities that are related in their operations or the existence of entities that are under common management.

4.05 FASB ASC 810-10-45-10 establishes, in the presentation of combined financial statements for a group of related entities, such as a group of commonly controlled entities, that intraentity transactions and profits or losses should be eliminated and that noncontrolling interests, foreign operations, different fiscal periods, or income taxes should be treated in the same manner as consolidated financial statements.

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[1] For additional discussion of variable interest entities (VIEs), see the preceding chapter. Several technical practice aids issued by the AICPA provide additional guidance in the form of nonauthoritative questions and answers that address various topics relevant to VIEs, including (*a*) combined versus consolidated financial statements, (*b*) presenting stand-alone financial statements of a VIE, and (*c*) implications for the auditor's report if the reporting entity does not consolidate the VIE. Readers should refer to Technical Questions and Answers sections 1400.29–.31 (AICPA, *Technical Practice Aids*).

4.06 The disclosures required in consolidated financial statements should be made, as well as disclosures relating specifically to combined financial statements. These include

- a statement to the effect that combined financial statements are not those of a separate legal entity.
- the names and year-ends of the major entities included in the combined group.
- the nature of the relationship between the entities.

The capital of each entity should be disclosed on the face of the financial statements or in a note, either in detail by entity if the number of entities is small or, if detailed disclosure is not practicable, in condensed form with an explanation of how the information was accumulated.

Presentation of Separate Financial Statements of Members of an Affiliated Group

4.07 Consolidated or combined financial statements of affiliated entities as the primary financial statements of an economic unit are normally recommended, but the needs of specific users may sometimes necessitate the presentation of separate financial statements for individual members of an affiliated group. The issuer of separate financial statements for a member of an affiliated group should make appropriate disclosures of related parties.

4.08 As provided in FASB ASC 850-10-05-3, examples of related party transactions include transactions between a parent entity and its subsidiaries, subsidiaries of a common parent, an entity and trusts for the benefit of employees, an entity and its principal owners, management, or members of their immediate families, and affiliates. FASB ASC defines *affiliate* as a party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity.

4.09 In accordance with FASB ASC 850-10-50-1, financial statements of a reporting entity that has participated in material related party transactions should disclose, individually or in the aggregate, the following:

- The nature of the relationship(s) involved[2]
- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period

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[2] As established by the Financial Accounting Standards Board *Accounting Standards Codification* 850-10-50-6, if the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities.

- Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement
- The information required by FASB ASC 740-10-50-17 related to deferred taxes

4.10 Additionally, FASB ASC 850-10-50-2 requires notes or accounts receivable from affiliated entities to be shown separately and not included under a general heading, such as notes receivable or accounts receivable.

Presentation of Separate Financial Statements of Members of an Affiliated Group That Constitute an Economic Unit

4.11 Presentation in a note to the financial statements of the condensed consolidated or combined balance sheet and statement of income of the members of the affiliated group that constitute the economic unit is also recommended.

Chapter 5

Other Accounting Considerations

Fair Value Measurements

5.01 As noted in FASB ASC 820-10-05-1, Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurement*, defines *fair value*, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The following paragraphs summarize some of the major provisions of FASB ASC 820 but are not intended as a substitute for reviewing FASB ASC 820 in its entirety.

5.02 The guidance contained in FASB ASC 820 applies to all entities, transactions, and instruments under other FASB ASC subtopics that require or permit fair value measurements except for the following:

- Accounting principles that address share-based payment transactions found in FASB ASC 718, *Compensation—Stock Compensation*, and FASB ASC 505-50.
- FASB ASC sections, subtopics, or topics that require or permit measurements that are similar to fair value but that are not intended to measure fair value, including both of the following:
  - — FASB ASC sections, subtopics, or topics that permit measurements that are based on, or otherwise use, vendor-specific objective evidence of fair value, which include FASB ASC 985-605 and FASB ASC 605-25
  - — FASB ASC 330, *Inventory*
- Accounting principles that address fair value measurements for purposes of lease classification or measurement under FASB ASC 840, *Leases*. This scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB ASC 805, *Business Combinations*, regardless of whether those assets and liabilities are related to leases.
- Certain practicability exceptions to fair value measurements in specific circumstances identified in "Pending Content" in FASB ASC 820-10-15-3.

Definition of Fair Value

5.03 The FASB ASC glossary 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." FASB ASC 820-10-35-5 states that a fair value measurement assumes that the transaction to sell the asset or transfer the liability either occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The FASB ASC glossary defines the *principal market* as "the market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability. The principal market (and thus, market participants) should be

considered from the perspective of the reporting entity, thereby allowing for differences between and among entities with different activities."

5.04 FASB ASC 820-10-35-3 and FASB ASC 820-10-30-2 provide that the hypothetical transaction to sell the asset or transfer the liability is considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the objective of a fair value measurement focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price). Conceptually, entry prices and exit prices are different. However, FASB ASC 820-10-30-3 explains that, in many cases, at initial recognition, a transaction price (entry price) will equal the exit price and, therefore, will represent the fair value of the asset or liability at initial recognition. In determining whether a transaction price represents the fair value of the asset or liability at initial recognition, the reporting entity should consider facts specific to the transaction and the asset or liability.

5.05 Paragraphs 7–8 of FASB ASC 820-10-35 state that the price should not be adjusted for transaction costs. However, if location is an attribute of the asset or liability (as might be the case for a commodity), the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability should be adjusted for the costs, if any, that would be incurred to transport the asset or liability to (or from) its principal (or most advantageous) market.

Application to Assets

5.06 FASB ASC 820-10-35-10 provides that a fair value measurement of an asset assumes the highest and best use of the asset by market participants, considering the use of the asset that is physically possible, legally permissible, and financially feasible at the measurement date. Highest and best use is determined based on the use of the asset by market participants, even if the intended use of the asset by the reporting entity is different.

5.07 FASB ASC 820-10-35-10 states that the highest and best use for an asset is established by one of two valuation premises: value in-use or value in-exchange. The highest and best use of the asset is in-use if the asset would provide maximum value to market participants principally through its use in combination with other assets as a group (as installed or otherwise configured for use). For example, value in-use might be appropriate for certain nonfinancial assets. The highest and best use of the asset is in-exchange if the asset would provide maximum value to market participants principally on a standalone basis. For example, value in-exchange might be appropriate for a financial asset. According to paragraphs 12–13 of FASB ASC 820-10-35, an asset's value in-use should be based on the price that would be received in a current transaction to sell the asset assuming that the asset would be used with other assets as a group and that those other assets would be available to market participants. An asset's value in-exchange is determined based on the price that would be received in a current transaction to sell the asset stand-alone.

Application to Liabilities

5.08 According to paragraphs 16–16A of FASB ASC 820-10-35, a fair value measurement assumes that both (*a*) the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled), and (*b*) the nonperformance risk relating to that liability is

the same before and after its transfer. Further, it is also assumed that a liability is exchanged in an orderly transaction between market participants. Certain liabilities, such as debt obligations, are traded in the marketplace as assets. However, many liabilities are rarely transferred in the marketplace due to contractual or other legal restrictions.

5.09 FASB ASC 820-10-35-16B states that if a quoted price in an active market for an identical liability is available, it represents a level 1 measurement. If that is not available, a reporting entity should measure fair value using one or more of the following techniques:

- A valuation technique that uses
  - — the quoted price of the identical liability when traded as an asset or
  - — quoted prices for similar liabilities or similar liabilities when traded as assets.
- Another valuation technique that is consistent with the principles of FASB ASC 820, such as an income or market approach

5.10 According to FASB ASC 820-10-35-16D, when measuring the fair value of a liability using the quoted price of the liability when traded as an asset, the reporting entity should adjust the quoted price for factors specific to the asset that are not applicable to the fair value measurement of the liability. For example, the quoted price for the asset may relate to a similar, but not identical, liability traded as an asset, or the unit of account for the asset may not be the same as for the liability.

5.11 FASB ASC 820-10-35-16G states that when measuring the fair value of a liability using a valuation technique, the reporting entity should ensure the fair value measurement is consistent with FASB ASC 820. For example, when using a technique based on the amount at the measurement date that the reporting entity would receive to enter into the identical liability, the inputs should reflect the assumptions that market participants would use (or the reporting entity's own assumption about the assumptions that market participants would use) in the principal or most advantageous market for issuance of a liability with the same contractual terms.

5.12 When estimating the fair value of a liability, FASB ASC 820-10-35-16E states that the reporting entity should not include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability because the effect of that restriction is already either implicitly or explicitly included in the other inputs to the fair value measurement.

5.13 Paragraphs 17–18 of FASB ASC 820-10-35 provide that a fair value measurement of a liability should reflect its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value.

Valuation Techniques

5.14 Paragraphs 24–35 of FASB ASC 820-10-35 describe the valuation techniques that should be used to measure fair value. Valuation techniques

consistent with the market approach, income approach, or cost approach should be used to measure fair value. These approaches are described as follows:

- The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. Valuation techniques consistent with the market approach include matrix pricing and often use market multiples derived from a set of comparables.
- The income approach uses valuation techniques to convert future amounts (for example, cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts. Valuation techniques consistent with the income approach include present value techniques, option-pricing models, and the multiperiod excess earnings method.
- The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (often referred to as current replacement cost). Fair value is determined based on the cost to a market participant (buyer) to acquire or construct a substitute asset of comparable utility, adjusted for obsolescence.

5.15 FASB ASC 820-10-35-24 states that valuation techniques that are appropriate in the circumstances and for which sufficient data are available should be used to measure fair value. In some cases, a single valuation technique will be appropriate (for example, when valuing an asset or liability using quoted prices in an active market for identical assets or liabilities). In other cases, multiple valuation techniques will be appropriate (for example, as might be the case when valuing a reporting unit) and the respective indications of fair value should be evaluated and weighted, as appropriate, considering the reasonableness of the range indicated by those results. Example 3 (paragraphs 35–41) of FASB ASC 820-10-55 illustrates the use of multiple valuation techniques. A fair value measurement is the point within that range that is most representative of fair value in the circumstances.

5.16 As explained by paragraphs 25–26 of FASB ASC 820-10-35, valuation techniques used to measure fair value should be consistently applied. However, a change in a valuation technique or its application is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances. Such a change would be accounted for as a change in accounting estimate in accordance with the provisions of FASB ASC 250, *Accounting Changes and Error Corrections*.

Present Value Techniques

5.17 Paragraphs 4–20 of FASB ASC 820-10-55 provide guidance on present value techniques. Those paragraphs neither prescribe the use of one specific present value technique nor limit the use of present value techniques to the three techniques discussed therein. These paragraphs state that a fair value measurement of an asset or liability using present value techniques should capture the following elements from the perspective of market participants as of the measurement date:

- An estimate of future cash flows
- Expectations about possible variations in the amount or timing (or both) of the cash flows

- The time value of money
- The price for bearing the uncertainty inherent in the cash flows (risk premium)
- Other case-specific factors that would be considered by market participants
- In the case of a liability, the nonperformance risk relating to that liability, including the reporting entity's (obligor's) own credit risk

5.18 FASB ASC 820-10-55-6 provides the general principles that govern any present value technique, as follows:

- Cash flows and discount rates should reflect assumptions that market participants would use in pricing the asset or liability.
- Cash flows and discount rates should consider only factors attributed to the asset (or liability) being measured.
- To avoid double counting or omitting the effects of risk factors, discount rates should reflect assumptions that are consistent with those inherent in the cash flows. For example, a discount rate that reflects expectations about future defaults is appropriate if using the contractual cash flows of a loan but is not appropriate if the cash flows themselves are adjusted to reflect possible defaults.
- Assumptions about cash flows and discount rates should be internally consistent. For example, nominal cash flows (that include the effects of inflation) should be discounted at a rate that includes the effects of inflation.
- Discount rates should be consistent with the underlying economic factors of the currency in which the cash flows are denominated.

5.19 FASB ASC 820-10-55-9 describes how present value techniques differ in how they adjust for risk and in the type of cash flows they use. For example, the discount rate adjustment technique (also called the traditional present value technique) uses a risk-adjusted discount rate and contractual, promised, or most likely cash flows. In contrast, method 1 of the expected present value techniques uses a risk-free rate and risk-adjusted expected cash flows. Method 2 of the expected present value technique uses a risk-adjusted discount rate (which is different from the rate used in the discount rate adjustment technique) and expected cash flows. In the expected present value technique, the probability-weighted average of all possible cash flows is referred to as the expected cash flows. The traditional present value technique and two methods of expected present value techniques are discussed more fully in FASB ASC 820-10-55.

5.20 This guide includes guidance about measuring assets and liabilities using traditional present value techniques. That guidance is not intended to suggest that the income approach is the only one of the three approaches that is appropriate in the circumstances, nor is it intended to suggest that the traditional present value technique described in the guide is preferred over other present value techniques.

The Fair Value Hierarchy

5.21 FASB ASC 820-10-35-51D emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, as stated by FASB ASC 820-10-35-9, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the

asset or liability (referred to as *inputs*). Paragraphs 37–58 of FASB ASC 820-10-35 establish a fair value hierarchy that distinguishes between (*a*) market participant assumptions developed based on market data obtained from sources independent of the reporting entity (observable inputs) and (*b*) the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances (unobservable inputs). Valuation techniques used to measure fair value should maximize the use of observable inputs and minimize the use of unobservable inputs.

5.22 The fair value hierarchy in FASB ASC 820-10-35 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The three levels are as follows:

- **Level 1 inputs.** Paragraphs 40–41 of FASB ASC 820-10-35 state that level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An *active market*, as defined by the FASB ASC glossary, is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and should be used to measure fair value whenever available, except as discussed in FASB ASC 820-10-35-16D, FASB ASC 820-10-35-42, and FASB ASC 820-10-35-43. FASB ASC 820-10-35-44 provides guidance on how the quoted price should not be adjusted because of the size of the position relative to trading volume (blockage factor), but rather would be measured within level 1 as the product of the quoted price for the individual instrument times the quantity held.
- **Level 2 inputs.** Paragraphs 47–51 of FASB ASC 820-10-35 explain that level 2 inputs are inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a level 2 input must be observable for substantially the full term of the asset or liability. Adjustments to level 2 inputs will vary depending on factors specific to the asset or liability. Those factors include the condition and location of the asset or liability, the extent to which the inputs relate to items that are comparable to the asset or liability (including those factors discussed in FASB ASC 820-10-35-16D), and the volume and level of activity in the markets within which the inputs are observed. An adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. As discussed in paragraph 48 of FASB ASC 820-10-35, level 2 inputs include
    - — quoted prices for similar assets or liabilities in active markets.
    - — quoted prices for identical or similar assets or liabilities in markets that are not active.
    - — inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves observable at commonly quoted intervals,

volatilities, prepayment speeds, loss severities, credit risks, and default rates).

— inputs that are derived principally from or corroborated by observable market data by correlation or other means (market-corroborated inputs).

- **Level 3 inputs.** According to FASB ASC 820-10-35-51, an adjustment that is significant to the fair value measurement in its entirety might render the measurement a level 3 measurement, depending on the level in the fair value hierarchy within which the inputs used to determine the adjustment fall. As discussed in paragraphs 52–55 of FASB ASC 820-10-35, level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should be developed based on the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, the reporting entity need not undertake all possible efforts to obtain information about market participant assumptions. Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk). Assumptions about risk include the risk inherent in the inputs to the valuation technique. A measurement (for example, a mark-to-model measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability. The reporting entity should not ignore information about market participant assumptions that is reasonably available without undue cost and effort. Therefore, the entity's own data used to develop unobservable inputs should be adjusted if information is readily available without undue cost and effort that indicates that market participants would use different assumptions. FASB ASC 820-10-55-22 discusses level 3 inputs for particular assets and liabilities.

As explained in FASB ASC 820-10-35-37, in some cases, the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the fair value hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

5.23 As discussed in FASB ASC 820-10-35-38, the availability of inputs relevant to the asset or liability and the relative reliability of the inputs might affect the selection of appropriate valuation techniques. However, the fair value hierarchy prioritizes the inputs to valuation techniques, not the valuation techniques. For example, a fair value measurement using a present value technique might fall within level 2 or level 3, depending on the inputs that are significant to the measurement in its entirety and the level in the fair value hierarchy within which those inputs fall.

5.24 As stated by FASB ASC 820-10-35-15, the effect on a fair value measurement of a restriction on the sale or use of an asset by a reporting entity

will differ depending on whether the restriction would be considered by market participants in pricing the asset. Example 6 (paragraphs 51–55) of FASB ASC 820-10-55 explains that restrictions that are an attribute of an asset and, therefore, would transfer to a market participant, are the only restrictions reflected in fair value.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

5.25 Paragraphs 59–62 of FASB ASC 820-10-35 create a practical expedient to measure the fair value of an investment on the basis of the net asset value per share of the investment (or its equivalent) determined as of the measurement date. Therefore, certain attributes of the investment, such as restrictions on redemption, and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the fair value of the investment if the practical expedient is used.

5.26 The practical expedient reduces complexity and improves consistency and comparability in the application of FASB ASC 820 while reducing the costs of applying FASB ASC 820. This guidance also improves transparency by requiring additional disclosures about investments within its scope to enable users of financial statements to understand the nature and risks of investments and whether the investments are probable of being sold at amounts different from net asset value per share.

5.27 According to FASB ASC 820-10-15-4, this guidance only applies to an investment that meets both of the following criteria:

a. The investment does not have a readily determinable fair value.

b. The investment is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 (investment activity, unit ownership, pooling of funds, and reporting entity) or, if one or more of the attributes specified in FASB ASC 946-10-15-2 are not present, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

5.28 Examples of investments, to which this guidance applies, may include hedge funds, private equity funds, real estate funds, venture capital funds, offshore fund vehicles, and funds of funds.

5.29 FASB ASC 820-10-35-58 states that classification within the fair value hierarchy of a fair value measurement of an investment that is within the scope and measured at net asset value per share requires judgment. This guidance provides considerations involving the ability to redeem the investment for determining the level within the fair value hierarchy that a fair value measurement of an investment at net asset value per share (or its equivalent) should be categorized.

5.30 Paragraphs 59–62 of FASB ASC 820-10-35 create a practical expedient to measure the fair value of an investment on the basis of the net asset value per share of the investment (or its equivalent) determined as of the measurement date. Therefore, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the fair value of the investment if the practical expedient is used.

Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

5.31 Paragraphs 51A–51H of FASB ASC 820-10-35 clarifies the application of FASB ASC 820 in determining fair value when the volume and level of activity for the asset or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, portions of paragraphs 59A–59I of FASB ASC 820-10-55 provide illustrations on the application of this guidance.

5.32 This guidance does not apply to quoted prices for an identical asset or liability in an active market (level 1 inputs). For example, although the volume and level of activity for an asset or liability may significantly decrease, transactions for the asset or liability may still occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

5.33 Consistent with FASB ASC 820-10-35-51D, when determining fair value when the volume and level of activity for the asset or liability has significantly decreased, the objective of a fair value measurement remains the same. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction (not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FASB ASC 820-10-35-51A lists a number of factors that may be evaluated to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability (or similar assets or liabilities) when compared with normal market activity. According to FASB ASC 820-10-35-51B, if, after evaluating the factors, the conclusion is reached that there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market conditions, transactions or quoted prices may not be determinative of fair value. Further analysis of the transactions or quoted prices is needed, and a significant adjustment to the transactions or quoted prices may be necessary to estimate fair value in accordance with FASB ASC 820-10. According to FASB ASC 820-10-35-51C, the objective is to determine the point within the range of fair value estimates that is most representative of fair value under the current market conditions. A wide range of fair value estimates may be an indication that further analysis is needed.

5.34 FASB ASC 820-10-35-51D states that determining the price at which willing market participants would transact at the measurement date under current market conditions if there has been a significant decrease in the volume and level of activity for the asset or liability depends on the facts and circumstances and requires the use of significant judgment. The reporting entity's intention to hold the asset or liability is not relevant, however, because fair value is a market-based measurement, not an entity-specific measurement.

5.35 According to FASB ASC 820-10-35-51E, an entity should evaluate the circumstances to determine whether the transaction is orderly based on the weight of the evidence. Circumstances that may indicate that a transaction is not orderly and guidance that should be considered in the determination are found at paragraphs 51E–51F of FASB ASC 820-10-35. Even if there has been a significant decrease in the volume and level of activity for the asset or liability, it is not appropriate to conclude that all transactions are not orderly (that is, distressed or forced). In making the determination about whether a transaction is orderly, an entity does not need to undertake all possible efforts but should not ignore information that is available without undue cost and effort. The

reporting entity would be expected to have sufficient information to conclude whether a transaction is orderly when it is party to the transaction. Refer to FASB ASC 820 for more information.

Disclosures

5.36 FASB ASC 820-10-50 discusses the disclosures required for assets and liabilities measured at fair value. "Pending Content" in FASB ASC 820-10-50-1 explains that the reporting entity should disclose information that enables users of its financial statements to assess both (*a*) for assets and liabilities measured at fair value on a recurring basis in periods subsequent to initial recognition or that are measured on a nonrecurring basis in periods subsequent to initial recognition, the valuation techniques and inputs used to develop those measurements and (*b*) for recurring fair value measurements using significant unobservable inputs (level 3), the effect of the measurements on earnings for the period.[*]

Fair Value Option

5.37 FASB ASC 825, *Financial Instruments*, creates a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measure for many financial instruments and certain other items, with changes in fair value recognized in the statement of activities as those changes occur. FASB ASC 825-10-35-4 explains that a business entity should report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An election is made on an instrument-by-instrument basis (with certain exceptions), generally when an instrument is initially recognized in the financial statements. The fair value option need not be applied to all identical items, except as required by FASB ASC 825-10-25-7. Most financial assets and financial liabilities are eligible to be recognized using the fair value option, as are firm commitments for financial instruments and certain nonfinancial contracts.

5.38 As explained in FASB ASC 825-10-15-5, specifically excluded from eligibility is an investment in a subsidiary that the entity is required to consolidate, an interest in a variable interest entity (VIE) that the entity is required to consolidate, employer's and plan's obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans and other forms of deferred compensation arrangements (or assets representing net overfunded positions in those plans), financial assets and liabilities recognized under leases (this does not apply to a guarantee of a third-party lease obligation or a contingent obligation arising from a cancelled lease), deposit liabilities of depository institutions, and financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity (including temporary equity).

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[*] In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU establishes new disclosure requirements and clarifies certain existing disclosures regarding level of disaggregation and inputs and valuation techniques. The amendments in this ASU became effective for interim and annual reporting periods beginning after December 15, 2009, except for the separate disclosures about purchases, sales, issuances, and settlements in the level 3 fair value measurement rollforward. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Examples related to the guidance in this ASU were added to FASB *Accounting Standards Codification* 820-10-55. The guidance referenced in this paragraph is amended by this ASU.

5.39 FASB ASC 825-10-45 and FASB ASC 825-10-50 also include presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. Paragraphs 1–2 of FASB ASC 825-10-45 state that entities should report assets and liabilities that are measured using the fair value option in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. To accomplish that, an entity should either (*a*) report the aggregate of both fair value and non-fair-value items on a single line, with the fair value amount parenthetically disclosed or (*b*) present separate lines for the fair value carrying amounts and the non-fair-value carrying amounts. As discussed in FASB ASC 825-10-25-3, upfront costs and fees, such as debt issue costs, may not be deferred for items which the fair value option has been elected.

Fair Value and Construction Industry Accounting

5.40 The fair value measurement provisions in FASB ASC 820 and FASB ASC 825 set forth many considerations affecting the way construction contractors determine the fair value of their financial assets and financial liabilities, including investments in debt and equity securities and derivative instruments, transferred receivables, and financial assets and financial liabilities acquired in a business combination. In addition, this statement affects the definition of fair values used to measure *nonfinancial* assets and liabilities, including the following:

- Certain impaired assets and liabilities (see paragraphs 5.41–.46)
- Goodwill and intangible assets (see paragraphs 5.47–.49)
- Assets retirement obligations (see paragraphs 5.50–.54)
- Nonmonetary transactions (see paragraph 3.10)
- Assets and liabilities acquired in a business combination

Impairment of Long-Lived Assets

Property, Plant, and Equipment

5.41 Many construction contractors have considerable amounts of owned equipment on their books that need to be routinely tested for impairment. FASB ASC 360-10 addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The FASB ASC glossary defines *impairment* as the condition that exists when the carrying amount of a long-lived asset (asset group) exceeds its fair value. The FASB ASC glossary defines an *asset group* as the unit of accounting for a long-lived asset or assets to be held and used, which represents the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities.

5.42 FASB ASC 360-10-35-21 establishes that a long-lived asset (asset group) should be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. The following are examples of such events or changes in circumstances:

- A significant decrease in the market price of a long-lived asset (asset group).

- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition.
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator.
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group).
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group).
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term *more likely than not* refers to a level of likelihood that is more than 50 percent.

5.43 FASB ASC 360-10-35-17 provides that an impairment loss should be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment should be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use or under development. An impairment loss should be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value. FASB ASC 820, discussed earlier in this chapter, provides guidance on fair value measurements.

5.44 As explained in FASB ASC 360-10-35-22, when a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and methods as required by FASB ASC 250 or the amortization period as required by FASB ASC 350, *Intangibles—Goodwill and Other*. Any revision to the remaining useful life of a long-lived asset resulting from that review also should be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability. However, any change in the accounting method for the asset resulting from that review should be made only after applying the provisions of FASB ASC 360-10.

5.45 FASB ASC 360, *Property, Plant, and Equipment*, provides guidance on the circumstances in which long-lived assets may be disposed of other than by sale. FASB ASC 360-10-35-47 explains that a long-lived asset to be abandoned is disposed of when it ceases to be used. If an entity commits to a plan to abandon a long-lived asset before the end of its previously estimated useful life, depreciation estimates should be revised in accordance with paragraphs 17–20 of FASB ASC 250-10-45 and FASB ASC 250-10-50-4 to reflect the use of the asset over its shortened useful life. FASB ASC 360-10-40-4 states that a long-lived asset to be disposed of in an exchange measured based on the recorded amount of the nonmonetary asset relinquished or to be distributed to owners in a spinoff is disposed of when it is exchanged or distributed.

5.46 In accordance with FASB ASC 360-10-35-43, a long-lived asset (disposal group) classified as held for sale should be measured at the lower of its carrying amount or fair value less cost to sell. If the asset (disposal group) is newly acquired, the carrying amount of the asset (disposal group) should be established based on its fair value less cost to sell at the acquisition date. A long-lived asset should not be depreciated (amortized) while it is classified as held for sale. Interest and other expenses attributable to the liabilities of a disposal group classified as held for sale should continue to be accrued.

Intangibles—Goodwill

5.47 *Goodwill*, as defined in the FASB ASC glossary, is the excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognized as goodwill includes acquired intangible assets that do not meet the criteria in FASB ASC 805 for recognition as an asset apart from goodwill. Paragraphs 1–3 of FASB ASC 350-20-35 explain that goodwill should not be amortized. Instead, goodwill should be tested for impairment at a level of reporting referred to as a reporting unit. The FASB ASC glossary defines *reporting unit* as an operating segment or one level below an operating segment (also known as a component). Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value. The fair value of goodwill can be measured only as a residual and cannot be measured directly. Therefore, FASB ASC 350-20-35 sets forth a methodology for determining a reasonable estimate of the value of goodwill for purposes of measuring an impairment loss. That estimate is referred to as the *implied fair value of goodwill*. The two-step impairment test discussed in paragraphs 4–13 of FASB ASC 350-20-35[†] should be used to identify potential goodwill impairment and measure the amount of a goodwill impairment loss to be recognized (if any).

Intangibles—Other

5.48 The FASB ASC glossary defines *intangibles* as assets (not including financial assets) that lack physical substance. The term *intangible assets* is used to refer to intangible assets other than goodwill. FASB ASC 350-30-35-1 states that the accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life shall be amortized; an intangible asset with an indefinite useful life shall not

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[†] ASU No. 2010-28, *Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*, modifies step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity considers whether any adverse qualitative factors indicate that an impairment may exist. The qualitative factors are consistent with the existing guidance and examples in FASB ASC 350-20-35-30, which requires that goodwill of a reporting unit be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

For public entities, the amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2010. Early adoption is not permitted. For nonpublic entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Nonpublic entities may early adopt the amendments using the effective date for public entities.

This guidance is located in FASB ASC 350-20-35 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 350-10-65-2.

be amortized. Paragraphs 18–20 of FASB ASC 350-30-35 explain that an intangible asset that is not subject to amortization should be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired. FASB ASC 360-10-35-21 includes examples of impairment indicators. The impairment test should consist of a comparison of the fair value of an intangible asset with its carrying amount. If the carrying amount of an intangible asset exceeds its fair value, an impairment loss should be recognized in an amount equal to that excess. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited.

5.49 FASB ASC 350-30-35-14 explains that an intangible asset that is subject to amortization should be reviewed for impairment in accordance with the impairment provisions applicable to long-lived assets in FASB ASC 360. In accordance with the recognition and measurement provisions in FASB ASC 360-10, an impairment loss should be recognized if the carrying amount of an intangible asset is not recoverable and if its carrying amount exceeds its fair value. After an impairment loss is recognized, the adjusted carrying amount of the intangible asset should be its new accounting basis. Subsequent reversal of a previously recognized impairment loss is prohibited. Refer to FASB ASC, available on the FASB website at www.fasb.org, for the full text of the accounting standards. This guide is not intended as a substitute for reading these FASB ASC topics.

Asset Retirement Obligations

5.50 Many construction contractors have mining operations or asphalt or concrete plants that have significant dismantling and restoration costs associated with retirement of the assets. FASB ASC 410-20 addresses financial accounting and reporting for *asset retirement obligations*, which are defined by the FASB ASC glossary as obligations associated with the retirement of a tangible long-lived asset. The FASB ASC glossary defines *retirement* as the other-than-temporary removal of a long-lived asset from service. That term encompasses sale, abandonment, recycling, or disposal in some other manner. However, it does not encompass the temporary idling of a long-lived asset. The guidance in FASB ASC 410-20 applies to the following:

- Legal obligations associated with the retirement of a tangible long-lived asset that result from the acquisition, construction, development or the normal operation of a long-lived asset, including any legal obligations that require disposal of a replaced part that is a component of a tangible long-lived asset. The FASB ASC glossary defines a *legal obligation* as an obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.
- An environmental remediation liability that results from the normal operation of a long-lived asset and that is associated with the retirement of that asset.
- A conditional obligation to perform a retirement activity. The FASB ASC glossary defines a *conditional asset retirement obligation* as a legal obligation to perform an asset retirement activity

in which the timing and method of settlement are conditional on a future event that may or may not be within the control of the entity. Uncertainty about the timing of settlement of the asset retirement obligation does not remove that obligation from the scope of FASB ASC 410-20 but will affect the measurement of a liability for that obligation.

- Obligations of a lessor in connection with leased property that meet the provisions in the preceding first list item.
- The costs associated with the retirement of a specified asset that qualifies as historical waste equipment as defined by EU Directive 2002/96/EC.

FASB ASC 410-20-15-3 provides certain exclusions to which the preceding guidance on asset retirement obligations does not apply.

5.51 Paragraphs 4–6 of FASB ASC 410-20-25 establish that the entity should recognize the fair value of a liability for an asset retirement obligation in the period in which it is incurred if a reasonable estimate of fair value can be made. If a reasonable estimate of fair value cannot be made in the period the asset retirement obligation is incurred, the liability should be recognized when a reasonable estimate of fair value can be made. Upon initial recognition of a liability for an asset retirement obligation, an entity should capitalize an asset retirement cost by increasing the carrying amount of the related long-lived asset by the same amount as the liability. The FASB ASC glossary defines *asset retirement cost* as the amount capitalized that increases the carrying amount of the long-lived asset when a liability for an asset retirement obligation is recognized.

5.52 FASB ASC 410-20-25-6 states that an entity should identify all its asset retirement obligations. An entity has sufficient information to reasonably estimate the fair value of an asset retirement obligation if any of the following conditions exist:

- It is evident that the fair value of the obligation is embodied in the acquisition price of the asset.
- An active market exists for the transfer of the obligation.
- Sufficient information exists to apply an expected present value technique.

5.53 FASB ASC 410-20-30-1 explains that an expected present value technique will usually be the only appropriate technique with which to estimate the fair value of a liability for an asset retirement obligation. Paragraphs 2–5 of FASB ASC 410-20-35 provide that an entity should subsequently allocate that asset retirement cost to expense using a systematic and rational method over its useful life. In periods subsequent to initial measurement, an entity should recognize period-to-period changes in the liability for an asset retirement obligation resulting from the following:

- The passage of time
- Revisions to either the timing or the amount of the original estimate of undiscounted cash flows

5.54 An entity should measure and incorporate changes due to the passage of time into the carrying amount of the liability before measuring changes resulting from a revision to either the timing or the amount of estimated cash

flows. An entity should measure changes in the liability for an asset retirement obligation due to passage of time by applying an interest method of allocation to the amount of the liability at the beginning of the period. The interest rate used to measure that change should be the credit-adjusted risk-free rate that existed when the liability, or portion thereof, was initially measured. That amount should be recognized as an increase in the carrying amount of the liability and as an expense classified as accretion expense. The FASB ASC glossary defines *accretion expense* as an amount recognized as an expense classified as an operating item in the statement of income resulting from the increase in the carrying amount of the liability associated with the asset retirement obligation. Refer to FASB ASC available on the FASB website at www.fasb.org for the full text of the accounting standards. This guide is not intended as a substitute for reading this FASB ASC topic.

Mandatorily Redeemable Stock ‡

5.55 FASB ASC 480, *Distinguishing Liabilities from Equity*, establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. FASB ASC 480-10-25-8 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. "Pending Content" in FASB ASC 480-10-25-4 states that a mandatorily redeemable financial instrument should be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. "Pending Content" in the FASB ASC glossary defines a *mandatorily redeemable financial instrument* as any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. "Pending Content" in FASB ASC 480-10-55-4 states that an example of a mandatorily redeemable financial instrument is a stock that must be redeemed upon the death or termination of the individual who holds it, which is an event that is certain to occur. Moreover, "Pending Content" in FASB ASC 480-10-30-1 states that mandatorily redeemable financial instruments should be measured initially at fair value.

5.56 FASB ASC 480-10-65-1 states that the effective date of FASB ASC 480 is deferred for mandatorily redeemable financial instruments issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants, as follows:

- For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of

‡ This guidance is codified at FASB ASC 480-10 and is labeled as "Pending Content" due to the transition and open effective date information discussed in FASB ASC 480-10-65-1.

FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those noncontrolling interests during the deferral period, in conjunction with FASB's ongoing projects. During the deferral period for certain mandatorily redeemable noncontrolling interests, all public entities as well as nonpublic entities that are Securities and Exchange Commission registrants are required to follow the disclosure requirements in paragraphs 1–3 of FASB ASC 480-10-50 as well as disclosures required by other applicable guidance.

FASB ASC 480 were effective for fiscal periods beginning after December 15, 2004.

- For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of FASB ASC 480 are deferred indefinitely pending further FASB action.
- Mandatorily redeemable financial instruments issued by SEC registrants are not eligible for either of those deferrals.

Other deferral provisions apply. Refer to FASB ASC, available on the FASB website at www.fasb.org, for the full text of the accounting standards.

5.57 FASB ASC 480 may have a significant impact on the financial statements of construction contractors. Many contractors are closely held, and many of them have buy-sell agreements requiring the entity to redeem the shares of the owners in the event of death or disability or other leave of employment. It is possible that such buy-sell agreements for share redemption would meet the definition of *mandatorily redeemable financial instruments* under FASB ASC 480. The application of the requirements of FASB ASC 480 may have significant effects on financial information and financial ratios of construction contractors, which could affect compliance with existing requirements of loan agreements, surety bonds, and other agreements.

Differences Between Financial Accounting and Income Tax Accounting

5.58 Differing and often conflicting objectives and needs in determining income for current income tax reporting and for financial reporting have led to the practice, common in the construction industry, of measuring income for income tax purposes by methods different from those used for financial reporting purposes.

5.59 As previously discussed, income determination in the construction contracting industry involves many varied and changing conditions over which a contractor may have little control. Under most contracts, cash payments, which frequently represent amounts in excess of contract profit, are withheld by the owner until final acceptance of the project and are paid to the contractor in a period or periods different from those in which the income is earned. Those conditions have led contractors to adopt acceptable income tax reporting policies that defer income recognition for tax purposes until contracts are completed or that report income from contracts on a cash basis or on the basis of billings.

5.60 Despite the acceptability and appropriateness of such methods for determining current tax payments, it is essential that the contractor, when measuring current financial status for financial reporting purposes, take into account all known factors regarding contract performance. The financial reports serve as the basis for management planning and control. The reports also provide bonding companies and lenders with information on the current contract and financial status.

5.61 The differences between the periodic amounts of contract income reported during the term of a contract for financial reporting and income tax purposes result in temporary differences FASB ASC 740, *Income Taxes*, is the primary FASB ASC topic for financial statement accounting for income taxes.

5.62 FASB ASC 740-10-15-2AA clarifies that the sections of FASB ASC 740-10 relating to accounting for uncertain tax positions are applicable to all entities, including tax-exempt not-for-profit entities, pass-through entities, and entities that are taxed in a manner similar to pass-through entities such as real estate investment trusts and registered investment companies. *Tax position*, as defined by the FASB ASC glossary, is a position in a previously filed tax return or a position expected to be taken in a future tax return that is reflected in measuring current or deferred income tax assets and liabilities for interim or annual periods. A tax position can result in a permanent reduction of income taxes payable, a deferral of income taxes otherwise currently payable to future years, or a change in the expected realizability of deferred tax assets. The term tax position also encompasses, but is not limited to

- a decision not to file a tax return.
- an allocation or a shift of income between jurisdictions.
- the characterization of income or a decision to exclude reporting taxable income in a tax return.
- a decision to classify a transaction, entity, or other position in a tax return as tax exempt.
- an entity's status, including its status as a pass-through entity or a tax-exempt not-for-profit entity.

5.63 FASB ASC 740 establishes financial accounting and reporting standards for the effects of income taxes that result from an entity's activities during the current and preceding years. It requires an asset and liability approach for financial accounting and reporting for income taxes. FASB ASC 740-10-05-7 states deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. FASB ASC 740-10-05-7 states the tax effects of transactions are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money. As established in FASB ASC 740-10-25-47, the effects of changes in tax rates or tax laws should be recognized at the date of enactment. When deferred tax accounts are adjusted for the effect of a change in tax laws or rates, the effect should be included in income from continuing operations for the period that includes the enactment date. FASB ASC 740-10-25-32 clarifies that the recognition of deferred tax assets and liabilities may have limited application to a nontaxable entity (for example, a partnership) that may not pay income taxes at the entity level.

5.64 Many of the various types of temporary differences are the same for contractors as they are for other business enterprises. In addition, the following operating and financial reporting characteristics in the construction industry affect the nature and types of temporary differences in the industry:

- For reasons previously discussed, it is often not desirable for contractors to use, for income tax purposes, the method of accounting for contracts that is appropriate for financial reporting purposes.
- Joint performance of contracts under formal venture agreements is often necessary, and this creates a separate tax accounting entity with its own contract accounting methods and tax accounting policies. Also, taxable periods and accounting methods of such an entity may not coincide with those of the venturers.

- When current estimates of contract performance indicate an ultimate loss, accounting principles require a current loss provision, which is not deductible currently for income tax purposes.

Accounting Methods Acceptable for Income Tax Purposes

5.65 In addition to the percentage-of-completion and completed-contract methods, contractors ordinarily have available to them the cash method and *accrual* methods (billings and costs) of accounting, among other methods, for determining taxable income. Certain conditions of eligibility for these different methods may apply. Contractors, like other taxpayers, are not ordinarily required to use the same method for both financial reporting and tax purposes. Effective tax planning may dictate the use of a different method for tax purposes.

Cash Method

5.66 The cash method has a potential tax advantage for a contractor because careful year-end scheduling of controllable receipts and disbursements can be used in tax planning. Under the cash method of computing taxable income, all items that represent gross income—whether in the form of cash, property, or services—are included in income for the taxable year in which they are received or constructively received. Expenditures are generally deducted as expenses in the taxable year in which they are paid. Income is constructively received in the taxable year in which it is credited to the taxpayer's account or set apart for him so that he may draw on it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A contractor using the cash method who intentionally defers or postpones billings to shift income from one period to another may be deemed to have constructively received as income amounts of billings deferred or postponed. The provisions of the contract and the actual performance on the project are the factors that determine when income is taxable. Although taxable income is affected by normal lags between billings and payments, a taxpayer reporting on a cash basis cannot arbitrarily determine the period in which income on a contract will be reported by arbitrarily selecting a billing date.

5.67 Under the cash method, contract costs are deductible in the year in which they are paid, even though the contract income has not been earned or received. For tax purposes, contract costs are deferred charges, not inventories. Although the cash basis method of reporting income cannot be applied to inventories, carrying minor amounts of inventories does not preclude a taxpayer from using that method. However, the cash method cannot be applied to inventories of large quantities of materials purchased and stored for future use without assignment for a specific contract. As provided in the Internal Revenue Code, a taxpayer in the home building business who builds speculative homes for resale must accumulate construction costs and deduct them in the year in which the sale of the property is reported, even though he may use the cash basis for tax purposes. Under those circumstances, construction costs are treated as work in progress. Also, an expenditure may be deductible only in part for the taxable year in which it is made if the expenditure is for an asset (for example, a depreciable asset or a three-year insurance policy) having a useful life that extends substantially beyond the close of the taxable year.

Accrual Method

5.68 An entity using an accrual method for income tax purposes reports as revenue amounts billed on contracts and as cost of earned revenue contract costs incurred to the date of the most recently rendered contract billing. Other expenditures are deductible as incurred. The accrual method may accelerate tax liabilities if gross margins on early billings are greater than gross margins on billings in the later stages of the contract. A contractor may elect to exclude retentions from income until they are received; otherwise, they are recognized when billed, which may create a cash flow disadvantage because retentions normally are not collected until after contract completion.

Chapter 6

Financial Statement Presentation

Balance Sheet Classification

6.01 The predominant practice in the construction industry is to present balance sheets with assets and liabilities classified as current and noncurrent, in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 210, *Balance Sheet*, on the basis of one year or the operating cycle (if it exceeds one year). According to FASB ASC 210-10-05-4, the balance sheets of most entities show separate classifications of current assets and current liabilities (commonly referred to as *classified balance sheets*) permitting ready determination of working capital.

6.02 Construction contractors may use either a classified or unclassified balance sheet:

- A classified balance sheet is preferable for entities whose operating cycle is one year or less. An entity whose operating cycle for most of its contracts is one year or less, but that periodically obtains some contracts that are significantly longer than normal, may use a classified balance sheet with a separate classification and disclosure for items that relate to contracts that deviate from its normal operating cycle. For example, if an entity with a normal cycle of one year obtains a substantial contract that greatly exceeds one year, it may still use a classified balance sheet if it excludes from current assets and liabilities the assets and liabilities related to the contract that are expected to be realized or liquidated after one year and discloses in the financial statements information on the realization and maturity of those items. The one-year basis of classification, where appropriate, presents information in a form preferred by many sureties and credit grantors as one of the many tools that they use to make analyses of a contractor's operations and financial statements.
- An unclassified balance sheet is preferable for entities whose operating cycle exceeds one year. An entity whose operating cycle exceeds one year may also use a classified balance sheet with assets and liabilities classified as current on the basis of the operating cycle if, in management's opinion, an unclassified balance sheet would not result in a meaningful presentation.

6.03 FASB ASC 910-235-50-2 states an entity should disclose liquidity characteristics of specific assets and liabilities if either of the following conditions is met:

- The entity's operating cycle exceeds one year.
- The entity uses an unclassified balance sheet.

6.04 If receivables include amounts representing balances billed but not paid by customers under contract retainage provisions, FASB ASC 910-310-50-4

states that a contractor should disclose, either in the balance sheet or in a note to the financial statements, all of the following:

- The amounts
- The portion, if any, expected to be collected after one year
- If practicable, the years in which the amounts are expected to be collected

6.05 Regarding certain liabilities common to construction contractors, FASB ASC 910-405-50-1 states information relating to accounts and retentions payable should be disclosed, including the amounts of retentions to be paid after one year and, if practicable, the year in which the amounts are expected to be paid.

Guidelines for Classified Balance Sheets

6.06 A classified balance sheet should be prepared in accordance with FASB ASC 210 and the guidelines discussed in the following paragraphs.

General Guidance

6.07 For most construction contractors, the operating cycle is difficult to measure with precision because it is determined by contracts of varying durations. The FASB ASC glossary defines the *operating cycle* as the average time intervening between the acquisition of materials or services and the final cash realization. The operating cycle of a contractor is determined by a composite of many individual contracts in various stages of completion. Thus, the operating cycle of a contractor is measured by the duration of contracts, that is, the average time intervening between the inception of contracts and the substantial completion of contracts.

6.08 According to the FASB ASC glossary, the term *current assets* is used to designate cash and other assets and resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. FASB ASC 210-10-45-1 states current assets generally include all of the following:

- Cash available for current operations and items that are cash equivalents
- Inventories of merchandise, raw materials, goods in process, finished goods, operating supplies, and ordinary maintenance material and parts
- Trade accounts, notes, and acceptances receivable
- Receivables from officers, employees, affiliates, and others, if collectible in the ordinary course of business within a year
- Installment or deferred accounts and notes receivable if they conform generally to normal trade practices and terms within the business
- Marketable securities representing the investment of cash available for current operations, including investments in debt and equity securities classified as trading securities under FASB ASC 320-10

- Prepaid expenses, such as insurance, interest, rents, taxes, unused royalties, current paid advertising services not yet received, and operating supplies

6.09 According to the FASB ASC glossary, the term *current liabilities* is used principally to designate obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities. Moreover, FASB ASC 210-10-45-8 explains that, as a balance sheet category, the classification of current liabilities generally includes obligations for items that have entered into the operating cycle, such as the following:

- Payables incurred in the acquisition of materials and supplies to be used in the production of goods or in providing services to be offered for sale
- Collections received in advance of the delivery of goods or performance of services
- Debts that arise from operations directly related to the operating cycle, such as accruals for wages, salaries, commissions, rentals, royalties, and income and other taxes
- Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months, such as the following:
  - — Short term debts arising from the acquisition of capital assets
  - — Serial maturities of long term obligations
  - — Amounts required to be expended within one year under sinking fund provisions
  - — Agency obligations arising from the collection or acceptance of cash or other assets for the account of third persons

FASB ASC 470-10-45 includes guidance on various debt transactions that may result in current liability classification. These transactions consist of due on demand loan agreements, callable debt agreements, and short term obligations expected to be refinanced.

6.10 In applying the foregoing definitions, the predominant practice in the construction industry for contractors whose operating cycle exceeds one year is to classify all contract-related assets and liabilities as current under the operating cycle concept and to follow other, more specific guidance in classifying other assets and liabilities. Following those general rules promotes uniformity of presentation and narrows the range of variations in practice The following is a list of types of assets and liabilities that are generally considered to be contract related and that should generally be classified as current under the operating cycle concept:

a. Contract-related assets include

  i. accounts receivable on contracts (including retentions);

  ii. unbilled contract receivables;

  iii. costs and estimated earnings in excess of billings;

  iv. other deferred contract costs; and

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

b. Contract-related liabilities include

   i. accounts payable on contracts (including retentions);

   ii. accrued contract costs;

   iii. billings in excess of costs and estimated earnings;

   iv. deferred taxes resulting from the use of a method of income recognition for tax purposes different from the method used for financial reporting purposes;

   v. advanced payments on contracts for mobilization or other purposes;

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

   vii. provision for losses on contracts in accordance with paragraphs 1–2 of FASB ASC 605-35-45.

6.11 Following the foregoing guidance in preparing classified balance sheets will promote consistency in practice and facilitate consolidation of construction contracting segments of an entity with segments not engaged in construction contracting.

Retentions Receivable

6.12 Circumstances may be such that retentions receivable may not be collected within one year (for example, the existence of special arrangements with owners). FASB ASC 910-310-45-1 states that the portion of retainages not collectible within one year, or within the operating cycle if it is longer than one year, shall be classified as noncurrent in a classified balance sheet.

6.13 Similarly, circumstances may be such that retentions payable will not be paid within an entity's normal operating cycle (for example, the existence of special arrangements with subcontractors or vendors), and these payables should be classified as noncurrent in a classified balance sheet.

Investments in Construction Joint Ventures

6.14 Chapter 3, "Accounting for and Reporting Investments in Construction Joint Ventures," of this guide provides guidance for investors on acceptable financial statement presentation of investments in construction joint ventures. If a joint venture investment 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 investor. Losses in excess of an investment should be presented as a liability, and the classification principle for assets should apply.

Equipment

6.15 The cost of equipment that is acquired for a specific contract, that will be used only on that contract, and that will be consumed during the life of the contract or disposed of at the conclusion of the contract should be classified as a contract cost.

Excess Billings

6.16 As previously noted, billings in excess of costs and estimated earnings should generally be classified as a current liability. However, to the extent that billings exceed total estimated costs at completion of the contract plus contract profits earned to date, such an excess should be classified as deferred income. Billings in excess of costs and estimated earnings should be regarded as obligations for work to be performed except when billings exceed total estimated costs at completion of the contract plus contract profits earned to date.

Liabilities

6.17 For an entity with an operating cycle in excess of one year, liabilities related to contracts should be classified as current on the basis of the operating cycle. For example, if a classified balance sheet is prepared using an operating cycle longer than one year, all contract-related liabilities maturing within that cycle should be classified as current. Other liabilities should be classified on the basis of the specific guidance in FASB ASC 210-10.

Deferred Income Taxes

6.18 A deferred tax liability or asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current year. Deferred tax assets and liabilities should be classified in accordance with paragraphs 4–10 of FASB ASC 740-10-45. Paragraphs 77–222 of FASB ASC 740-10-55 provide illustrations of the balance sheet classification of certain types of deferred income taxes, including methods of reporting construction contracts.[1]

Offsetting or Netting Amounts

6.19 A basic principle of accounting is that assets and liabilities should not be offset unless a right of offset exists. Thus, the net debit balances for certain contracts should not ordinarily be offset against net credit balances relating to others unless the balances relate to contracts that meet the criteria for combining in paragraphs 5–9 in FASB ASC 605-35-25.

6.20 Paragraphs 3–4 of FASB ASC 605-35-45 recognize the principle of offsetting in discussing the two accepted methods of accounting for long term construction-type contracts. For the percentage-of-completion method, current assets may include costs and recognized income not yet billed with respect to certain contracts. Liabilities (in most cases current liabilities) may include billings in excess of costs and recognized income with respect to other contracts. For the completed-contract method, an excess of accumulated costs over related billings should be shown in the balance sheet as a current asset, and an excess of accumulated billings over related costs should be shown among the liabilities (in most cases as a current liability). If costs exceed billings on some contracts, and billings exceed costs on others, the contracts should ordinarily be segregated so that the figures on the asset side include only those contracts on which costs exceed billings, and those on the liability side include only those on which billings exceed costs.

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[1] Please refer to chapter 5 , "Other Accounting Considerations," for further discussion of accounting for income taxes.

6.21 Offsetting should be applied in the same way under the percentage-of-completion method.

6.22 Although the suggested mechanics of segregating contracts between those on which costs exceed billings and those on which billings exceed costs do not indicate whether billings and related costs should be presented separately or combined (netted), separate disclosure in comparative financial statements is preferable because it shows the dollar volume of billings and costs (but not an indication of future profit or loss). In addition, grantors of credit, such as banks and insurance companies, have expressed a preference for separate disclosure. Disclosure may be made by short extension of the amounts on the balance sheet or in the notes to the financial statements. Thus, under the percentage-of-completion method, the current assets may disclose separately total costs and total recognized income not yet billed for certain contracts, and current liabilities may disclose separately total billings and total costs and recognized income for other contracts. The separate disclosure of revenue and costs in statements of income is the generally accepted practice. Only through comparable presentation of such data in the balance sheet can the reader adequately evaluate the contractor's comparative position.

6.23 In accordance with paragraphs 1–2 of FASB ASC 910-405-45, an advance received on a cost-plus contract should not offset against accumulated costs unless it is a payment on account of work in progress. Such advances are made to provide a revolving fund and are not applied as partial payment until the contract is nearly or fully completed. However, advances that are payments on account of work in progress should be shown as a deduction from the related asset. FASB ASC 910-405-50-2 states that the amounts of advances that are payments on account of work in progress should be disclosed.

6.24 For advance payments on a terminated government contract, FASB ASC 912-405-45-5 states the financial statements of the contractor issued before final collection of the claim should reflect any balance of those advances as deductions from the claim receivable.

Disclosures in Financial Statements

6.25 In addition to the financial statement disclosures generally required in an entity's financial statements, the following disclosures should be made in the notes to the financial statements of contractors if they are not disclosed in the body of the financial statements.

Significant Accounting Policies

6.26 In accordance with the disclosure sections of FASB ASC 323, *Investments—Equity Method and Joint Ventures*; FASB ASC 605, *Revenue Recognition*; and FASB ASC 910, *Contractors—Construction*, significant accounting policy disclosures should include the following:

a. *Method of reporting affiliated entities.* Information relating to the method of reporting by affiliated entities should be disclosed, along with the disclosures recommended in chapter 4, "Financial Reporting by Affiliated Entities."

b. *Operating cycle.* If the operating cycle exceeds one year, the range of contract durations should be disclosed.

c. *Revenue recognition.* The method of recognizing income (percentage of completion or completed contract) should be disclosed:

   i. If the percentage-of-completion method is used, the method or methods of measuring extent of progress toward completion (for example, cost to cost, labor hours) should be disclosed.

   ii. If the completed-contract method is used, the reason for selecting that method should be indicated (for example, numerous short term contracts for which financial position and results of operations reported on the completed-contract basis would not vary materially from those resulting from use of the percentage-of-completion method; inherent hazards or undependable estimates that cause forecasts to be doubtful).

d. *Method of reporting joint venture investments.* The method of reporting joint ventures should be disclosed, along with other joint venture disclosures.

e. *Contract costs.*

   i. The aggregate amount included in contract costs representing unapproved change orders, claims, or similar items subject to uncertainty concerning their determination or ultimate realization, plus a description of the nature and status of the principal items comprising such aggregate amounts and the basis on which such items are recorded (for example, cost or realizable value).

   ii. The amount of progress payments netted against contract costs at the date of the balance sheet.

f. *Deferred costs.* For costs deferred either in anticipation of future sales (precontract costs that are not within the scope of FASB ASC 720-15) or as a result of an unapproved change order, the policy of deferral and the amounts involved should be disclosed.

Revised Estimates

6.27 Revisions in estimates of the percentage of completion are changes in accounting estimates as defined in FASB ASC 250, *Accounting Changes and Error Corrections*. FASB ASC 605-35-50-9 states that although estimating is a continuous and normal process for contractors, FASB ASC 250-10-50-4 requires disclosure of the effect of revisions if the effect is material. The effect on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), and any related per-share amounts of the current period should be disclosed for a change in estimate that affects several future periods. Additionally, if a change in estimate does not have a material effect in the period of change but is reasonably certain to have a material effect in later periods, a description of that change in estimate should be disclosed whenever the financial statements of the period of change are presented.

Backlog on Existing Contracts

6.28 In the construction industry, one of the most important indexes is the amount of backlog on uncompleted contracts at the end of the current year as compared with the backlog at the end of the prior year. Contractors are

encouraged to present backlog information for signed contracts on hand whose cancellation is not anticipated because many surety and bank underwriters utilize and rely on this disclosure when considering providing credit to the contractor. Backlog can be reported by industry or type of facility and by location (domestic or foreign). Additional disclosures that an entity may want to make include backlog on letters of intent and a schedule showing backlog at the beginning of the year, new contract awards, revenue recognized for the year, and backlog at the end of the year. The presentation of backlog information is desirable only if a reasonably dependable determination of total revenue and a reasonably dependable estimate of total cost under signed contracts or letters of intent can be made. Information on signed contracts should be segregated from information on letters of intent if both types of information are presented.

Receivables

6.29 If receivables include billed or unbilled amounts under contracts representing unapproved change orders, claims, or similar items subject to uncertainty concerning their determination or ultimate realization, the balance sheet, or a note to the financial statements, should disclose the amount, a description of the nature and status of the principal items comprising the amount, and the portion, if any, expected to be collected after one year. Paragraphs 25–31 of FASB ASC 605-35-25 discuss accounting for change orders and claims.

6.30 If receivables include other amounts representing the recognized sales value of performance under contracts that have not been billed and were not billable to customers at the date of the balance sheet, these amounts, a general description of the prerequisites for billings, and the portion, if any, expected to be collected after one year should be disclosed.

6.31 FASB ASC 605-35-50-8 states a contract claim receivable should be disclosed as a contingent asset in accordance with FASB ASC 450-30-50-1 if at least one of the following conditions exist:

- It is not probable that the claim will result in additional contract revenue.
- The claim amount cannot be reliably estimated.
- It is probable that a claim will result in additional contract revenue and that the claim amount can be reliably estimated, but the claim exceeds the recorded contract costs.

As provided by FASB ASC 450-30-50-1, adequate disclosure should be made of contingencies that might result in gains, but care should be exercised to avoid misleading implications about the likelihood of realization.

6.32 FASB ASC 910-310-50-3 states that if receivables include amounts maturing after one year, the following should be disclosed:

- The amount maturing after one year and, if practicable, the amounts maturing in each year
- Interest rates on major receivable items, or on classes of receivables, maturing after one year or an indication of the average interest rate or the range of rates on all receivables

6.33 In accordance with FASB ASC 910-310-50-4, if receivables include amounts representing balances billed, but not paid, by customers under

contract retainage provisions, a contractor should disclose, either in the balance sheet or in a note to the financial statements, all of the following:

- The amounts
- The portion (if any) expected to be collected after one year
- If practicable, the years in which the amounts are expected to be collected

FASB ASC 910-310-45-1 states the portion of retainages not collectible within one year, or within the operating cycle if it is longer than one year, should be classified as noncurrent in a classified balance sheet.

6.34 Related party receivables are common in the construction industry. Refer to chapter 4 for the definition of *related parties*. In accordance with FASB ASC 210-10-45-4, the concept of the nature of current assets contemplates the exclusion from current assets of loans or advances to affiliates, officers, and employees that are not expected to be collected within 12 months. FASB ASC 850-10-50-2 states notes or accounts receivable from officers, employees, or affiliated entities must be shown separately and not included under a general heading such as "notes receivable" or "accounts receivable." If the reporting entity and 1 or more other entities are under common ownership or management control, and if the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship should be disclosed even though no transactions exist between the entities. This guidance specific to control relationships is found in FASB ASC 850-10-50-6.

6.35 As provided in FASB ASC 850-10-50-1, financial statements should include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures should include the following:

- The nature of the relationship(s) involved.
- A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements.
- The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.
- Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement.
- When a contractor is a member of a consolidated tax return but issues separate financial statements, disclosures in those statements should include the following in accordance with FASB ASC 740-10-50-17:

— Aggregate amount of current and deferred tax expense for each earnings statement presented

— The principal provisions of the method used to allocate the consolidated amount of current and deferred tax expense to members and the nature and effect of any changes in that method for the years presented

Accounting by Creditors for Impairment of a Loan

6.36 Paragraphs 16–18 of FASB ASC 310-10-35 provide that a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. The term *probable* is used consistent with its use in FASB ASC 450-20, which defines *probable* as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. That range is from probable to remote, as follows:

- *Probable* means that the future event or events are likely to occur.
- *Reasonably possible* means that the chance of the future event or events occurring is more than remote but less than likely.
- *Remote* means the chance of the future event or events occurring is slight.

Paragraphs 20–30 of FASB ASC 310-10-35 explain that measuring impairment of a loan requires judgment and estimates, and the eventual outcomes may differ from those estimates. Creditors have latitude to develop measurement methods that are practical in their circumstances. When a loan is impaired, a creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is a collateral-dependent loan. FASB ASC 310-10-35-37 establishes that the net carrying amount of the loan should at no time exceed the recorded investment in the loan. Refer to FASB ASC 310-40 for specific application of this guidance to loans that are restructured in a troubled debt restructuring.

6.37 Authoritative guidance on loan impairments does not address how a creditor should recognize, measure, or display interest income on impaired loans. Accordingly, creditors may use existing methods for recognizing interest income described in FASB ASC 310-10-35-39 or two alternative methods described in FASB ASC 310-10-35-40. Required disclosures for impaired loans are included in paragraphs 15–20 of FASB ASC 310-10-50.[*]

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[*] Financial Accounting Standards Board (FASB) Accounting Standards Update (ASU) No. 2010-20, *Receivables (Topic 310): Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, requires disclosures that facilitate a user's understanding of the nature of credit risk inherent in the entity's portfolio of financing receivables; how that risk is analyzed and assessed in arriving at the allowance for credit losses; and the changes and reasons for those changes in the allowance for credit losses. For public entities, the disclosures as of the end of a reporting period are now effective and are listed as "Pending Content." Also for public entities, the disclosures

(continued)

Disclosures of Certain Significant Risks and Uncertainties

6.38 In accordance with FASB ASC 275-10-50-1, reporting entities should include in their financial statements disclosures about the risks and uncertainties existing as of the date of those statements in the following areas:

- Nature of their operations
- Use of estimates in the preparation of financial statements
- Certain significant estimates
- Current vulnerability due to certain concentrations

These four areas of disclosure are not mutually exclusive. The information required by some may overlap. Accordingly, the disclosures required by FASB ASC 275-10 may be combined in various ways, grouped together, placed in diverse parts of the financial statements, or included as part of the disclosures made pursuant to the other requirements within generally accepted accounting principles. Although the guidance in FASB ASC 275, *Risks and Uncertainties*, applies to complete interim financial statements, it does not apply to condensed or summarized interim financial statements. If comparative financial statements are presented, the disclosure requirements apply only to the financial statements for the most recent fiscal period presented. Paragraphs 1–19 of FASB ASC 275-10-55 provide examples of disclosures, and paragraphs 2–10 of FASB ASC 605-35-55 provide examples of disclosures required by FASB ASC 275 as they specifically pertain to the effects of possible near term changes in contract estimates.

6.39 FASB ASC 310-10-50-25 clarifies that certain loan products have contractual terms that expose entities to risks and uncertainties described in the preceding paragraph. FASB ASC 825-10-55-1 states that certain loan products may increase a reporting entity's exposure to credit risk and thereby may result in a concentration of credit risk as that term is used in FASB ASC 825-10, either as an individual product type or as a group of products with similar features. Among other required disclosures about each significant concentration, FASB ASC 825-10-50-21 states that information about the (shared) activity, region, or economic characteristic that identifies the concentration should be disclosed, except for certain financial instruments identified in FASB ASC 825-10-50-22. According to paragraphs 1–2 of FASB ASC 825-10-55, possible shared characteristics on which significant concentrations may be determined include, but are not limited to

- borrowers subject to significant payment increases,
- loans with terms that permit negative amortization, and
- loans with high loan-to-value ratios.

(footnote continued)

about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

ASU No. 2011-01, *Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, temporarily delays the effective date of the disclosures about troubled debt restructurings in ASU No. 2010-20 for public entities. The delay is intended to allow the board time to complete its deliberations on what constitutes a troubled debt restructuring. The effective date of the new disclosures about troubled debt restructurings for public entities and the guidance for determining what constitutes a troubled debt restructuring will then be coordinated. Currently, that guidance is anticipated to be effective for interim and annual periods ending after June 15, 2011.

This guidance is located in FASB ASC 310-10-50 and is labeled as "Pending Content" due to the transition and open effective date information discussed in paragraphs 2–3 of FASB ASC 310-10-65.

Judgment is required to determine whether loan products have terms that give rise to a concentration of credit risk.

Accounting for Weather Derivatives

6.40 The existence of weather derivative contracts (that is, contracts indexed to climatic or geological variables) is relatively new; however, their market presence is rapidly growing. The construction industry is one of the market areas where the potential use of weather derivatives would likely expand. FASB ASC 815-45 prescribes the accounting treatment, establishes disclosure requirements, and provides implementation guidance and illustrations for weather derivatives.

Chapter 7

Auditing Within the Construction Industry*

7.01 The objective of the auditing section of the guide is to assist the independent auditor in auditing the financial statements of entities in the construction industry. Independent auditors often encounter a variety of complex problems in such engagements because of the nature of operations in the industry and because of the methods used in accounting for contracts.

Audit Focus

7.02 In audits of the financial statements of construction contractors, the primary focus is on the profit centers, usually individual contracts, for recognizing revenues, accumulating costs, and measuring income. Obtaining a thorough understanding of the contracts that underlie the financial statements is an important part of the audit plan that describes in detail the nature, timing, and extent of risk assessment and further audit procedures performed in the audit. Evaluation of the profitability of contracts or profit centers is also central to the total audit process and the determination of whether the information in the financial statements is presented in conformity with generally accepted accounting principles.

7.03 The methods and the bases of measurement used in accounting for contracts affects the independent auditor's review of estimated contract costs to complete, measures of extent of progress toward completion, revenues, and gross profit to form a conclusion on the reasonableness of costs, revenue, and gross profit allocated to the period audited. Thus, much of the independent auditor's work involves evaluating subjective estimates relating to future events, a process which involves highly technical data.

7.04 Paragraph .01 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), states that "(t)he auditor must obtain a sufficient understanding of the entity and its environment, including its internal control . . ." In the audits of the financial statements of construction contractors, the areas that normally receive particular attention include an entity's internal control, its operating systems and procedures, its project management, the nature of its contracting work, its history of performance and profitability, and other relevant accounting and operating factors. The auditor's primary consideration is to obtain a sufficient understanding of the entity to assess the risks of material misstatement at both the overall financial statement level and the assertion level.

7.05 In accordance with paragraph .40 of AU section 314, the auditor should obtain a sufficient understanding of internal control by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Areas of focus in the construction industry are contract revenues, costs, gross profit or loss, and related contract receivables and payables. The auditor should

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* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

design and perform further audit procedures whose nature, timing, and extent are linked to the assessed risks of material misstatement at the relevant assertion level. In the construction industry, the significant measurement uncertainty associated with the application of the percentage-of-completion method of accounting for contracts, among other judgmental matters associated with construction contracts, may present significant risks that, in the auditor's professional judgment, require special audit consideration. For further discussion of the auditor's responsibilities toward significant risks, refer to chapter 9, "Planning the Audit, Assessing and Responding to Audit Risk, and Additional Auditing Considerations," of this guide.

Scope of Auditing Guidance Included in This Guide

7.06 The auditing section of this guide deals primarily with auditing procedures peculiar to audits of the financial statements of construction contractors. It does not discuss auditing procedures that are not unique to such audits or that do not require special application in them; such procedures may be found in other sources of generally accepted auditing standards. The focus in this section of the guide is primarily on the three standards of field work and on auditing procedures used in compliance with those three standards. Those standards include the following:

- The auditor must adequately plan the work and must properly supervise any assistants.
- The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
- The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Chapter 8

Controls in the Construction Industry[*]

8.01 The discussion of controls in this chapter is primarily from management's perspective and relates to management's responsibility to establish and maintain adequate internal control over financial reporting. As directed in Section 404(a) of the Sarbanes-Oxley Act of 2002 (the act), management of an issuer must assess the effectiveness of the entity's internal control over financial reporting and include in the entity's annual report to shareholders management's conclusion as a result of that assessment about whether the entity's internal control is effective. This chapter is not intended to provide guidance to management of public construction contractors on how to comply with the requirements of the act. However, the "SEC Requirements for Management's Report on Internal Control Over Financial Reporting" section in this chapter provides some general information on internal control reporting requirements established by the act.

8.02 This chapter is not intended to provide the auditor with comprehensive auditing guidance but may serve as an overview of factors that will enable the auditor to better understand the entity and its environment, including its internal control. As indicated in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.

8.03 Unlike auditors of nonissuers, auditors of issuers are directed under Section 404(b) of the act to attest to and report on management's assessment of the entity's internal control over financial reporting in conjunction with their audit of the entity's financial statements.[†] Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of*

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[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[†] A company that is an accelerated filer or large accelerated filer, as defined in Rule 12b-2 under the Securities Exchange Act of 1934, is required to comply with the Securities and Exchange Commission (SEC) rules regarding Section 404(b) of the Sarbanes-Oxley Act of 2002 (the act). Under Rule 12b-2, subject to periodic and annual reporting criteria, an *accelerated filer* is an issuer with market value of $75 million, but less than $700 million; a *large accelerated filer* is an issuer with market value of $700 million or greater. Nonaccelerated filers have not been subject to this requirement due to a number of deferrals of the requirement. Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) affords small issuers an exemption from the internal controls auditor attestation requirement of Section 404(b) of the act. Section 404(b) requires registered public accounting firms that prepare or issue audit reports for an issuer to attest to, and report on, the assessment made by the issuer's management of the company's internal controls.

Section 989G of the Dodd-Frank Act added to the act Section 404(c) to exempt from the attestation requirement smaller issuers that are neither accelerated filers nor large accelerated filers under Rule 12b-2. This exemption effectively applies to *nonaccelerated filers*, those companies with less than $75 million in market capitalization.

On September 21, 2010, the SEC issued Final Rule 33-9142 to implement Section 989G of the Dodd-Frank Act.

The full text of the release is available at www.sec.gov/rules/final/2010/33-9142.pdf.

Financial Statements (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements. Further discussion of the standard can be found in chapter 9, "Planning the Audit, Assessing and Responding to Audit Risk and Additional Auditing Considerations," of this guide.[1]

8.04 This chapter presents a general discussion of some of the desirable control activities in the construction industry. Although not all the controls identified are found in every construction entity, their discussion can serve as guidance concerning what might be considered adequate controls for a contractor. This discussion considers aspects of controls in the following areas:

- Estimating and bidding
- Project administration and contract evaluation
- Job site accounting and controls
- Billing procedures (including determination of reimbursable costs under cost-plus contracts)
- Contract costs
- Contract revenues
- Construction equipment
- Claims, extras, and back charges
- Joint ventures
- Internal audit function

The last section of this chapter discusses Securities and Exchange Commission (SEC) requirements for management's report on internal control over financial reporting.

Estimating and Bidding

8.05 Effective controls over the estimating and bidding functions provide reasonable assurance that contracts are bid or negotiated on the basis of data carefully compiled to take into account all factors that will affect the cost, revenue, and profitability of each contract. Unreliable estimates can obscure losses on contracts in their early stages or can overstate or understate the estimated profitability of contracts.

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[1] On May 23, 2007, the SEC approved new interpretive guidance designed to help management of public companies strengthen internal control over financial reporting and enhance compliance under Section 404 of the act. The guidance, previously proposed as Release No. 33-8762, *Management's Report on Internal Control Over Financial Reporting*, provides, among other significant provisions, interpretive guidance for management regarding its evaluations of internal control over financial reporting and clarification regarding the auditor's reporting requirements pursuant to Section 404(b) of the act. Under the guidance, management can align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting. The SEC also approved rule amendments providing that an entity that performs an evaluation in accordance with the new interpretive guidance also satisfies the annual evaluation required by Securities Exchange Act of 1934 Rules 13a-15 and 15d-15. Among other rule changes, the SEC also redefined the term *material weakness* and revised the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting to require the auditor to express an opinion directly on the effectiveness of internal control over financial reporting and not on management's evaluation process. Readers may refer to the SEC website at www.sec.gov for more information.

8.06 Controls over estimating and bidding are necessary to provide for adequate documentation, clerical verification, overall review of estimated costs, and approval of all bids by the appropriate levels of management. Examples of control activities related to estimating and bidding include the following:

- Using contract estimates based on contract specifications, plans, and drawings to provide assurance that the estimates of contract costs reflect all relevant cost elements
- Using escalation clauses in contracts, if possible, to protect against unforeseen increases in material and labor costs, particularly for contracts of long duration
- Verifying the clerical accuracy of final contract estimates
- Reviewing the completeness and reasonableness of the final estimate and obtaining at least two independent estimates on complex or large contracts
- Establishing procedures to preclude arbitrary, undocumented management-level adjustments to estimated costs

8.07 Preparation and maintenance of the estimate of contract costs and the accounting records in a consistent manner will permit subsequent detailed comparison of actual costs with estimated costs. A record of the bids submitted by competing firms normally should be maintained, if those bids are available. Such cost and bid information is helpful to management and may provide them with evidence of the reliability of their estimating and bidding process.

8.08 Having assigned personnel to regularly perform monitoring procedures is necessary to ensure that controls over the estimating and bidding functions are operating effectively. For instance, a contractor might assign personnel to perform the following tasks:

- Review the quantities of material and hours of labor in bid estimates and compare them to the customers' specifications.
- Compare and relate estimated material costs to published vendor price lists, price quotations, subcontractors' bids, or other supporting documentation.
- Compare and relate estimated labor rates to union contracts and other documentation supporting labor rates, payroll taxes, and fringe benefits.
- Compare and relate estimated equipment costs to the rates charged by suppliers for rental or used by the contractor to allocate the cost of owned equipment to jobs.
- Consider the effects of potential cost increases during the period of the contract, including historical trends, the anticipated results of future labor negotiations, the effect of unusual geographic location, the sources and availability of materials and labor, and inflation.
- Verify the clerical accuracy of estimates.
- Determine that estimates are reviewed and approved by designated management personnel.
- Review contracts periodically to assess the extent and effect of management changes or revisions of bids without supporting data, such as revised cost estimates.

- Update estimates periodically based on documented discussions with engineering personnel responsible for the project.

Project Administration and Contract Evaluation

8.09 The quality and extent of project management often determine whether a construction contract is profitable or unprofitable. Timely and reliable progress, cost, and status reports on each contract are essential for management to evaluate the status and profitability of each project and to identify problems at an early stage. Regularly scheduled meetings with project managers and periodic management visits to job sites may also enhance the effectiveness of project administration.

8.10 In order to estimate the profit or loss on a contract in progress, it is essential that management review and evaluate regularly the status of each contract in progress. That procedure provides information that enables management to take corrective action to improve performance on a given contract, and such an evaluation is an integral part of effective internal control. Normally, the review should include a comparison of the detailed actual contract costs and the current estimate of costs to complete all phases of the project with the details of the original estimate and the total contract price. Other information to be considered in the review includes the following items:

- Cost records, which may be used for a comparison of the principal components of actual costs with original estimates
- Open purchase orders and commitments
- Reports, such as engineering progress reports, field reports, and project managers' status reports
- Conferences with project engineers and independent architects
- Correspondence files
- Change orders, including unpriced and unsigned change orders

8.11 Controls over subcontract costs should provide that payments to subcontractors are made only on the basis of work performed, that performance bonds are obtained, and that retentions are recorded and accounted for properly.

Job Site Accounting and Controls

8.12 The size and location of some construction projects may require a contractor to establish an accounting office at the job site, and all or part of the accounting function relating to that project—including payrolls, purchasing, disbursements, equipment control, and billings—may be performed at the job site. Establishing adequate internal control at job site accounting offices may be difficult because such offices are temporary and may be staffed with a limited number of trained accounting personnel. Therefore, it is essential that management pay particular attention to the areas discussed in the following paragraphs.

8.13 The temporary nature of the employment of most construction workers and the frequent practice of paying them in cash can make the establishment of controls difficult. Construction contractors ordinarily should consider having internal auditors, or corporate administrative personnel, periodically disburse or observe payrolls at job sites to strengthen controls over payrolls.

8.14 Established accounting procedures normally dictate that a designated level of management authorize all material purchases at job sites and clearly specify the types of acceptable documentation as evidence of receipt of materials. Additionally, effective accounting procedures prohibit making payments for materials without proper authorization and evidence of receipt.

8.15 Adequate physical controls over equipment, materials, and supplies at job sites help prevent loss by pilferage or unauthorized usage. Adequate internal control also includes taking an inventory of surplus materials at the completion of a contract and monitoring the subsequent disposition of such materials for adherence to company policy and appropriate accounting treatment. Maintaining effective supervision over job site offices, particularly if the size or nature of a contractor does not permit the establishment of an internal audit function, is also an important control.

Billing Procedures

8.16 Billing procedures in the construction industry differ from those in other industries. A typical manufacturing entity, for example, normally bills a customer upon the shipment of its product. In contrast, billing procedures in the construction industry vary widely among entities and are often not correlated with performance. Different types of contracts and different ways of measuring performance for billing purposes are prevalent. For example, billings may be based on various measures of performance, such as cubic yards excavated, architects' estimates of completion, costs incurred on cost-plus type contracts, or time schedules. Also, the data required to prepare a billing for a fixed-price contract differ from the data required for a cost-plus contract.

8.17 Adequate internal controls normally provide that personnel responsible for billing receive accurate, timely information from job sites and include billing procedures designed to recognize unique contract features. Because billing and payment terms often vary from contract to contract, the personnel responsible for billing normally should be familiar with the terms of the contracts. Billings that are not made in accordance with the terms of the contract generally should be approved by designated management personnel.

8.18 A contractor's receivables usually include retentions, that is, amounts that are not due until contracts are completed or until specified contract conditions or guarantees are met. Retentions are governed by contract provisions and are typically a fixed percentage (for example, 5 percent or 10 percent) of each billing. Some contracts provide for a reduction in the percentage retained on billings as the contract nears completion. Effective billing procedures and related internal control provide that a contractor bill retentions in accordance with the terms of a contract and that accounts are reviewed periodically to determine that retention payments are ultimately received. A contractor ordinarily should also have a routine procedure for filing liens at the time of each billing to provide assurance that lien rights are protected before they expire.

8.19 To provide continuing assurance that desirable internal control is maintained over the billing function, it is essential that assigned personnel regularly perform monitoring procedures. A contractor might assign personnel to perform the following tasks:

- Relate billings, including retentions, to the terms of the original contract and of approved change orders

- Accumulate and retain the data necessary to prepare and support billings, including costs incurred to date, engineers' estimates of completion, architects' certifications, and other pertinent information

Contract Costs

8.20 A contractor uses information on contract costs to control costs, evaluate the status and profitability of contracts, and prepare customer billings. Thus, the importance of accurate cost information cannot be overemphasized.

8.21 Contract cost records should facilitate detailed comparisons of actual costs with estimated costs and provide for the classification and summarization of costs into appropriate categories such as materials, subcontract charges, labor, labor-related costs, equipment costs, and overhead. It is essential that the accounting system be capable of producing detailed cost reports for management and project managers. Their review of the reports serves to identify potential problems on contracts, check on the reasonableness of the cost records, and minimize the possibility of having unauthorized costs charged to the contract.

8.22 Controls over contract costs, including the manner in which they are applied and the assignment of responsibility to designated personnel, are essential mechanisms to achieving the aforementioned objectives. Control activities might include, for example, periodic agreement of the detailed contract cost records to the general ledger control records and ensuring that proper cutoffs are made at the close of each accounting period. Other control activities that assigned personnel might regularly perform include

- comparing and relating the quantities and prices of materials charged to contracts to vendors' invoices, purchase orders, and evidence of receipt of materials and, if applicable, the withdrawal and return of documents from central stores.
- documenting labor charged to contracts by reference to payroll records and related documents (such as time cards, union contracts or pay authorizations, authorized deductions, and cancelled payroll checks) and reviewing payroll distribution to individual contracts.
- relating subcontract costs charged to contracts to the terms specified in the subcontract agreements and supporting documents.
- inspecting performance, guarantee, and similar bonds of subcontractors.
- comparing and relating retentions payable to subcontractors to subcontract agreements.
- inspecting waivers of lien on completed work from subcontractors.
- approving back charges, extras, and claims.
- comparing and relating equipment rental costs charged to contracts (*a*) to the contractor's standard rates for owned equipment and vendor invoices or rental agreements for leased equipment and (*b*) to delivery reports, production or maintenance records, or similar data.
- comparing equipment costs charged directly to a contract (purchased for exclusive use on a particular contract, such as a

cement plant and related trucks) to vendor invoices and related documents, and control the disposition of such equipment.

- reviewing the accumulation and allocation of indirect costs to contracts.
- reviewing the accumulation and segregation of reimbursable costs under cost-plus contracts.

A contractor's monitoring of controls over contract costs ensures that internal control over contract costs continue to operate effectively. This process involves assessment by appropriate personnel of the design and operation of controls on a timely basis and responding to the results of the assessment.

Contract Revenues

8.23 It is important that controls over contract revenues be designed to provide reliable information on the amount and timing of contract revenue. The types of controls established depend on the method of revenue recognition used. Relevant considerations when designing these types of controls include the amount of revenue expected from contracts and the procedures and information used either in measuring progress toward completion (to determine the amount of earned revenue under the percentage-of-completion method) or in determining when a contract is substantially completed (under the completed-contract method).

8.24 Control activities that assigned personnel might regularly perform include

- preparing and supporting current estimates of total revenue under each contract in process.
- processing and approving change orders and informing personnel responsible for performance of contracts of those change orders.
- determining that revenue arising from unpriced change orders and claims does not exceed the related recoverable costs, and that only costs that are reimbursable in accordance with the terms of cost-plus contracts are included in revenue.
- providing for timely notification of, and adjustments for, contract cancellations and postponements.
- selecting methods to measure progress that are suitable to the circumstances and apply the methods consistently.
- accumulating and verifying the information used to measure the extent of progress toward completion, such as total cost incurred, total labor hours incurred, and units of output, depending on the method used.
- verifying the accuracy of the computations of the percentage of completion, earned revenue, and the cost of earned revenue.
- reviewing and documenting contracts reported on the completed-contract basis for consistent application of completion criteria.
- evaluating periodically the profitability of contracts and providing for losses on loss contracts in full at the earliest date on which they are determinable.
- reconciling periodically the total earned revenue on a contract to total billings on the contract.

A contractor's monitoring of controls over contract revenues ensures that internal control continues to operate effectively.

Construction Equipment

8.25 Contractors frequently have substantial investments in construction equipment. The dollar amounts involved and the necessity of charging equipment costs to contracts make it necessary to maintain effective controls over equipment. Records normally should be maintained for all major equipment, including adequate cost information that is in agreement with the general accounting records; this information enables the contractor to charge each project with costs related to the equipment being used on it. Other essential controls include having reporting procedures in place to control and record the transfer of equipment between projects, having the project managers review periodic equipment reports that include the location of the equipment, and performing periodic inventories of field equipment at the completion of each project. During economic downturns, equipment frequently becomes idle; therefore, it is necessary to have procedures in place to ensure that such equipment is identified and its carrying amount is evaluated for recoverability in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 360, *Property, Plant, and Equipment*, as discussed in chapter 2, "Accounting for Performance of Construction-Type Contracts," of this guide.

8.26 Adequate controls over small equipment, such as power hand tools, at the job site prevent loss or pilferage. Such equipment is often charged directly to a contract.

Claims, Extras, and Back Charges

8.27 Controls over claims, extras, back charges, and similar items are necessary to provide reasonable assurance that such items are properly documented and provide for the accumulation of related revenues and costs. For example, one desirable procedure is to require written authorizations for change orders from an authorized customer representative before doing extra work. Another effective control is to have procedures in place for identifying and evaluating the financial accounting and reporting implications of claims filed against the contractor pursuant to FASB ASC 450, *Contingencies*, including those arising from litigation and assessments.

Joint Ventures

8.28 Control over the operations of joint ventures is essential for the financial success of the venture and the participating contractors. Although the nature and extent of control over the operations and the accounting records of joint ventures vary with each venture, a joint venture participant generally should be satisfied that adequate accounting records and desirable controls are maintained.

Internal Audit Function

8.29 Contractors engaged in large, complex, and diverse operations especially benefit from internal auditing. An internal audit staff may conduct both operational and financial reviews at a contractor's administrative offices as well

as at job sites. The reviews generally should cover the estimates of cost to complete and the methods used to measure performance on individual contracts. Internal auditors ordinarily should be involved in testing and evaluating every important control area discussed in this chapter. Their intimate involvement can provide management with continuous feedback on the effectiveness of internal control and the degree of compliance with company policies, and such involvement can enable the internal auditors to make recommendations for improvements in the entity's internal control.

8.30 One of the objectives of internal audits at job sites is to determine whether personnel at the sites are complying with the contractor's established policies and practices. Such audits may involve a physical inspection of equipment and review and testing of expenditures (including payroll disbursements) from a job site office, status reports to the home office, field equipment records, and contract billings to determine their appropriateness.

SEC Requirements for Management's Report on Internal Control Over Financial Reporting

8.31 As directed by Section 404 of the act, the SEC adopted final rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the entity's internal control over financial reporting. See the SEC website at www.sec.gov/rules/final/33-8238.htm for the full text of the regulation.

8.32 The SEC rules clarify that management's assessment and report is limited to *internal control over financial reporting*. Furthermore, SEC rules do not require management to consider other aspects of control, such as controls pertaining to operating efficiency. The SEC's definition of *internal control* encompasses the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) definition, but the SEC does not mandate that the entity use COSO as its criteria for judging effectiveness.

Annual Reporting Requirements

8.33 Under the SEC rules, a domestic issuer's annual 10-K must include the following:

- *Management's annual report on internal control over financial reporting*. This report on the entity's internal control over financial reporting should contain
  - — a statement of management's responsibilities for establishing and maintaining adequate internal control over financial reporting.
  - — a statement identifying the framework used by management to evaluate the effectiveness of the entity's internal control over financial reporting.
  - — management's assessment of the effectiveness of the entity's internal control over financial reporting as of the end of the most recent fiscal year, including a statement about whether internal control over financial reporting is effective. This discussion must include disclosure of any

material weakness in the entity's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if one or more material weaknesses exist in the entity's internal control over financial reporting.

— a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on the effectiveness of the issuer's internal control over financial reporting.[‡]

- *Attestation report of the registered public accounting firm*. This is the registered public accounting firm's attestation report on the effectiveness of the issuer's internal control over financial reporting.
- *Changes in internal control over financial reporting*. This report must disclose any change in the entity's internal control over financial reporting that has materially affected or is reasonably likely to materially affect the entity's internal control over financial reporting.

Quarterly Reporting Requirements

8.34 The SEC rules also require management to evaluate any change in the entity's internal control that occurred during a fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the entity's internal control over financial reporting.

8.35 Additionally, management is required to evaluate the effectiveness of the entity's disclosure controls and procedures and issue a report about their effectiveness on a quarterly basis. With these rules, the SEC introduced a new term, *disclosure controls and procedures*, which is different from *internal controls over financial reporting* and much broader.

8.36 As defined, *disclosure controls and procedures* encompass the controls over all material financial *and nonfinancial information* in Securities Exchange Act of 1934 reports. Information that would fall under this definition that would *not* be part of an entity's internal control over financial reporting might include the signing of a significant contract, changes in a strategic relationship, management compensation, or legal proceedings.

[‡] See footnote † of this chapter for discussion of the requirement for nonaccelerated filers to file an auditor's attestation report on internal control over financial reporting.

Chapter 9

Planning the Audit, Assessing and Responding to Audit Risk, and Additional Auditing Considerations[*]

Scope of This Chapter

9.01 In accordance with AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), an independent auditor plans, conducts, and reports the results of an audit in accordance with generally accepted auditing standards (GAAS). Auditing standards provide a measure of audit quality and the objectives to be achieved in an audit. The preceding chapter discusses, from the perspective of management, the features of effective internal control that a contractor ordinarily should establish and maintain. This chapter provides guidance primarily on the application of the standards of fieldwork. Specifically, this chapter provides guidance on the risk assessment process (which includes, among other things, obtaining an understanding of the entity and its environment, including its internal control) and some general auditing considerations for construction contractors.

9.02 In some instances, a practitioner may be engaged to examine and to express an opinion on the design and operating effectiveness of a nonissuer's internal control over financial reporting that is integrated with an audit of the nonissuer's financial statements. The auditor's responsibility in connection with this type of attest engagement is beyond the scope of this guide. This type of engagement is discussed in AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*). AT section 501 converges the standards practitioners use for reporting on a nonissuer's internal control with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards). AT section 501 is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2008.

9.03 Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements conducted under the standards of the PCAOB. This chapter is not intended to provide guidance to auditors on how to comply with the requirements of Auditing Standard No. 5 although it highlights, as appropriate, significant differences between GAAS and PCAOB standards.

Considerations for Audits Performed in Accordance With PCAOB Standards[†]

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[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

[†] In August 2010, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related*

(continued)

Paragraph 6 of Auditing Standard No. 5 clarifies that the objectives of the integrated audits are not identical, and the auditor must plan and perform the work to achieve the objectives of both audits. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously, which are to obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and to obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of the financial statements.

Planning and Other Auditing Considerations

9.04 The objective of an audit of a construction contractor's financial statements is to express an opinion on whether its financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP) in the United States. To accomplish that objective, the independent auditor's responsibility is to plan and perform the audit to obtain reasonable assurance (a high, but not absolute, level of assurance) that material misstatements, whether caused by errors or fraud, are detected. This section addresses general planning considerations and other auditing considerations relevant to construction contractors.

Considerations for Audits Performed in Accordance With PCAOB Standards

PCAOB Ethics and Independence Rule 3526, *Communication with Audit Committee Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), requires CPA firms to present—in writing—all relationships it has with a potential client that may bear on independence to a company's Audit Committee before accepting the engagement. Further, Rule 3526 requires CPA firms, on an annual basis, to present—in writing—all relationships it has with a current client that may bear on independence to a company's Audit Committee.

Planning the Audit

9.05 The first standard of field work states, "The auditor must adequately plan the work and must properly supervise any assistants." AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), establishes requirements and provides guidance on the considerations and activities applicable to planning and supervision of an audit conducted in accordance with GAAS, including appointment of the independent auditor; preliminary engagement activities; establishing an understanding with the client in the form of an engagement letter; preparing a detailed, written audit plan; determining the

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(footnote continued)

Amendments to PCAOB Standards (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). With this release, the PCAOB adopted eight auditing standards related to the auditor's assessment of, and response to, risk that will supersede six of the board's interim auditing standards and related amendments to PCAOB standards. These standards are effective for audit engagements conducted pursuant to the standards of the PCAOB for fiscal years beginning on or after December 15, 2010. Refer to the preface of this guide for important information about the release and applicability of these standards. Readers can download the entire release, which includes full text of the standards, at http://pcaobus.org/.

extent of involvement of professionals with specialized skills; and communicating with those charged with governance and management. Audit planning also involves developing an overall audit strategy for the expected conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control.

9.06 Paragraph .03 of AU section 311 states that the auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control. Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit of financial statements and internal control over financial reporting in accordance with PCAOB standards (subsequently referred to as *integrated audit*), refer to paragraph 9 of Auditing Standard No. 5 regarding planning considerations.

Auditor's Communication With Those Charged With Governance

9.07 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), provides a framework for effective two-way communication between the auditor and those charged with governance and identifies certain specific matters that the auditor must communicate. Paragraph .03 of AU section 380 defines *those charged with governance* as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the term *board of directors* or *audit committee* used elsewhere in GAAS. Note that this section does not establish requirements regarding the auditor's communication with an entity's management or owners unless they are also charged with a governance role. Paragraph .22 of AU section 380 provides that when all of those charged with governance are involved in managing the entity, the auditor should consider whether communication with person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity.

9.08 As provided in paragraph .49 of AU section 380, matters that may contribute to effective two-way communication include discussion of the purpose of communications, the form in which communications will be made, the person(s) on the audit team and among those charged with governance who will communicate regarding particular matters, the auditor's expectation that the communication will be two-way, the process for taking action and reporting back on matters communicated by the auditor, and the process for taking action and reporting back on matters communicated by those charged with governance. The communication process will vary with the circumstances,

including the size and governance structure of the entity; how those charged with governance operate; and the auditor's view of the significance of the matters to be communicated. The importance of effective two-way communication is evidenced by the statement in paragraph .62 of AU section 380 that if, in the auditor's judgment, the two-way communication between the auditor and those charged with governance is not adequate, there is a risk the auditor may not have obtained all the audit evidence required to form an opinion on the financial statements.

9.09 Paragraph .23 of AU section 380 identifies the following matters that the auditor should communicate with those charged with governance:

- The auditor's responsibilities under GAAS
- An overview of the planned scope and timing of the audit
- Significant findings from the audit

9.10 Readers can refer to AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), and chapter 11, "Other Audit Considerations," of this guide for guidance pertaining to the communication of internal control related matters. Readers can refer to AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), and chapter 12, "Consideration of Fraud in a Financial Statement Audit," of this guide for guidance pertaining to communication about possible fraud. For additional matters to be communicated to those charged with governance, readers can refer to appendix A of AU section 380. Nothing in AU section 380 precludes the auditor from communicating any other matters to those charged with governance.

Audit Risk

9.11 AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), states that audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level.

9.12 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk of material misstatement (consisting of inherent risk and control risk) and (*b*) the detection risk. Paragraph .23 of AU section 312 states that auditors should assess the risk of material misstatement at the relevant assertion level as a basis for further audit procedures (tests of controls or substantive procedures). It is not acceptable to simply deem risk to be *at the maximum*. This assessment may be in qualitative terms such as high, medium, and low, or in quantitative terms such as percentages.

9.13 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of

internal control. For audits of construction contractors, a major area of risks of misstatements is in the area of construction contracts. The contracts have a pervasive effect at the account balance, class of transactions, and disclosure level. The factors in exhibit 9-1 indicate the effect of various aspects of construction contracts on audit risk.

Exhibit 9-1

Factor	*Characteristics That Normally Reduce Audit Risk*	*Characteristics That Normally Increase Audit Risk*
Percent of contract complete	• 0% to 10% • > 90 %	• 10% to 90%
Size of project	• Relatively small job	• Relatively large job
Type of project	• Simple/routine • Within contractor's expertise	• Complex, one of a kind • Not within contractor's expertise
Timing and scheduling	• Short-term project • Work is on schedule • Comfortable time frame • No penalties for late completion	• Long-term project • Work is falling behind schedule • Accelerated time frame • Significant penalties for late completion
Location	• Established area with past successful projects • Materials and labor readily available	• New area • Remote area—materials and labor not readily available
Weather	• Low susceptibility to adverse weather	• High susceptibility to adverse weather
Owner/investor	• Many previous contracts with contractor • Solid financial position	• Very few previous contracts with contractor • Weak financial position
Subcontractors	• Large portion of work performed by subcontractors • Many previous contracts with contractor • Solid financial position • Majority of significant subcontract agreements finalized	• Small portion of work performed by subcontractors • Very few previous contracts with contractor • Weak financial position • Majority of significant subcontract agreements not finalized
Bid spread	• Narrow variances in bid amounts among competing contractors	• Significant variances in bid amounts among competing contractors
Profit fade	• No significant profit fade	• Significant profit fade

Factor	Characteristics That Normally Reduce Audit Risk	Characteristics That Normally Increase Audit Risk
Underbilling	• Nominal underbilling (cost and estimated earnings in excess of billings)	• Unusual/significant underbilling
Type of contract	• Cost-type, clear definition of reimbursable costs	• Fixed-price • Cost-type, difficult to determine reimbursable costs
Claims	• No claims	• Significant claims
Material costs	• Low susceptibility to price escalations during performance of contract	• High susceptibility to price escalations during performance of contract

Planning Materiality

9.14 Audit risk and materiality, among other matters, need to be considered together in designing the nature, timing, and extent of audit procedures and in evaluating the results of those procedures. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

9.15 The determination of what is material to the users is a matter of professional judgment. The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements as a whole. For example, total equity may be a good benchmark for contractors because bonding capacity is often calculated using total equity multiplied by a factor to arrive at a rule of thumb for total contracts that an entity may bond.

Considerations for Audits Performed in Accordance With PCAOB Standards

When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 20 of Auditing Standard No. 5 regarding materiality considerations.

Tolerable Misstatement

9.16 The initial determination of materiality is made for the financial statement as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements. To do so, the auditor should determine one or more levels of tolerable misstatement. Paragraph .34 of AU section 312 defines *tolerable misstatement* (or *tolerable error*) as the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels.

Qualitative Aspects of Materiality

9.17 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if a reasonable possibility exists that it could lead to a material contingent liability or a material loss of revenue.

9.18 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Use of Assertions in Obtaining Audit Evidence

9.19 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with U.S. GAAP, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories.

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/ Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Accuracy/ Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Under-standability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

9.20 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur and then designing further audit procedures that are responsive to the assessed risks.

Understanding the Entity, Its Environment, and Its Internal Control

9.21 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), provides guidance about implementing the second standard of field work, as follows:

> The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

9.22 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Paragraph .05 of AU section 314 states that throughout this process, the auditor should also follow the guidance in AU section 316. See chapter 12 for additional guidance pertaining to AU section 316.

Risk Assessment Procedures

9.23 As described in AU section 326, audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. Paragraph .21 of AU section 326 states that the auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures, by themselves, do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures. In accordance with paragraph .06 of AU section 314, the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

- Inquiries of management and others within the entity
- Analytical procedures
- Observation and inspection

See paragraphs .06–.13 of AU section 314 for additional guidance on risk assessment procedures.

Discussion Among the Audit Team

9.24 In obtaining an understanding of the entity and its environment, including its internal control, AU section 314 states that there should be discussion among the audit team. In accordance with paragraph .14 of AU section 314, the members of the audit team, including the auditor with final responsibility for the audit, typically the engagement partner, should discuss the susceptibility of the entity's financial statements to material misstatements. This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to fraud.

Understanding the Entity and Its Environment

9.25 Paragraph .03 of AU section 314 states that obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with GAAS. In accordance with paragraph .04 of AU section 314, the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient (*a*) to assess risks of material misstatement of the financial statements and (*b*) to design and perform further audit procedures (tests of controls and substantive tests).

9.26 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies (see the following section for further discussion)

Refer to appendix A of AU section 314 for examples of matters that the auditor may consider in obtaining an understanding of the entity and its environment relating to categories (a)–(d).

Review of Contracts

9.27 As part of obtaining the required understanding described in the preceding paragraphs, the auditor should review the terms of a representative sample of the contractor's contracts applicable to the period under audit. These should include both contracts with customers and contracts with subcontractors. Information that the auditor would expect to find is set forth in the following. The auditor should use this information in the preliminary review of contracts and also in the other stages of the audit:

- Job number
- Type of contract
- Contract price
- Original cost estimate and related gross profit
- Billing and retention terms
- Provisions for changes in contract prices and terms, such as escalation, cancellation, and renegotiation
- Penalty or bonus features relating to completion dates and other performance criteria
- Bonding and insurance requirements
- Location and description of project

9.28 Contract files may indicate bids entered by other contractors. If these are available, the auditor should investigate significant differences between such bids and the related contracts to evaluate whether there may be inherent errors in the estimating and bidding process.

Understanding of Internal Control

9.29 Paragraph .40 of AU section 314 states that the auditor should obtain an understanding of the 5 components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor should obtain a sufficient understanding by performing risk assessment procedures to

- evaluate the design of controls relevant to an audit of financial statements and
- determine whether they have been implemented.

9.30 The auditor should use the understanding to

- identify types of potential misstatements,
- consider factors that affect the risks of material misstatement, and
- design tests of controls, when applicable, and substantive procedures.

9.31 Obtaining an understanding of internal controls is different from testing the operating effectiveness of internal control. The objective of obtaining an understanding of internal control is to evaluate the design of controls and determine whether they have been implemented for the purpose of assessing the risks of material misstatement.[1] In contrast, the objective of testing the operating effectiveness of internal controls is to determine whether the controls, as designed, prevent or detect a material misstatement.

9.32 Paragraph .41 of AU section 314 defines internal control as "a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations." Internal control consists of five interrelated components:

- The control environment
- Risk assessment
- Information and communication systems
- Control activities
- Monitoring

Refer to paragraphs .40–.101 of AU section 314 for a detailed discussion of the internal control components.

9.33 In obtaining an understanding of internal control, the auditor should obtain sufficient knowledge of the information system as discussed in AU section 314. An entity's use of IT[2] may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives, and its operating units or business functions. As part of gaining a sufficient understanding, the auditor should

- obtain an understanding of how the incorrect processing of transactions is resolved.

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[1] Technical Questions and Answers (TIS) section 8200.11, "Ineffective Controls" (AICPA, *Technical Practice Aids*), states that if, prior to the performance of risk assessment procedures, an auditor's belief that controls over financial reporting are either nonexistent or ineffective does not exempt the auditor from the evaluation and documentation of those controls as set forth in AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). For additional nonauthoritative guidance pertaining to internal control and the risk assessment standards (Statement on Auditing Standards Nos. 104–111), refer to the entirety of TIS section 8200, *Internal Control* (AICPA, *Technical Practice Aids*).

[2] IT encompasses automated means of originating, processing, storing, and communicating information and includes recording devices, communication systems, computer systems (including hardware and software components and data), and other electronic devices. An entity's use of IT may be extensive; however, the auditor is primarily interested in the entity's use of IT to initiate, record, process, and report transactions or other financial data.

- obtain an understanding of the entity's information system relevant to financial reporting, including how transactions originate within the entity's business process.
- obtain an understanding of how IT affects control activities that are relevant to planning the audit.
- consider whether the entity has responded adequately to the risks arising from IT.[3]

To obtain this understanding, the auditor should perform risk assessment procedures, such as inquiries of appropriate management, supervisory, and staff personnel; inspection of documents and records; and observation of activities and operations. The auditor will also achieve this understanding through previous experience with the contractor. Internal control questionnaires, narrative descriptions, flowcharts, decision tables, analyses of IT systems, and other techniques are examples of common techniques used in this phase of the audit because those techniques enable the auditor to approach the understanding of internal control in a systematic manner and provide an effective means of documentation.

9.34 Paragraph .97 of AU section 314 states that the auditor should obtain an understanding of the major types of activities that the entity uses to monitor internal control and how those activities are used to initiate corrective actions to its controls. The monitoring of controls involves assessing the design and operation of controls on a timely basis to ensure that controls continue to operate effectively. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. To obtain audit evidence about relevant monitoring controls, the auditor might make inquiries and observations of entity personnel that would help the auditor determine the extent to which the contractor's personnel are performing their assigned responsibilities in accordance with the established controls.

9.35 Another component of internal control, in addition to monitoring, is an entity's control activities. Paragraph .89 of AU section 314 states that the auditor should obtain an understanding of those control activities relevant to the audit. Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Examples of specific control activities include authorization, segregation of duties, safeguarding, and asset accountability. An audit does not require an understanding of all the control activities; however, control activities for which the auditor is required to evaluate are identified in paragraphs .115–.117 of AU section 314. With regards to segregation of duties, the auditor might make inquiries and observations of entity personnel that would help the auditor determine the extent to which the contractor's assignment of responsibilities among the various personnel within the organization reduces the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Smaller organizations may find that using management oversight of the incompatible activities may help achieve an appropriate segregation of duties.

9.36 If the contractor has an internal audit function, the auditor, in accordance with the provisions of AU section 322, *The Auditor's Consideration*

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[3] See footnote 2.

of the Internal Audit Function in an Audit of Financial Statements (AICPA, *Professional Standards*), may take into consideration the existence of an internal audit function in determining the nature, timing, and extent of auditing procedures to be performed.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, refer to paragraphs 16–19 of Auditing Standard No. 5 for a discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

9.37 A wide variety of conditions, such as the materiality of specific contracts, influence the auditor's selection of specific audit procedures. The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. Paragraph .21 of AU section 311 states that the audit plan should include

- a description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
- a description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure.
- a description of other audit procedures to be carried out for the engagement in order to comply with GAAS.

For audits of construction contractors, the audit plan should include the review of significant contracts. During the course of the audit, the auditor may need to revise the audit plan to reflect the results of the auditor's risk assessment procedures or tests of the effectiveness of the contractor's internal control, for example.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously
>
> - to obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end.
> - to obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.
>
> When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the entity's internal control over financial reporting, as discussed in paragraph B2 of appendix B PCAOB Auditing Standard No. 5. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and

to plan and perform further tests of controls, particularly in response to identified control deficiencies.

If, during the audit of internal control over financial reporting, the auditor identifies a control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the audit risk in the audit of the financial statements to an appropriately low level, as provided in paragraph B6 of appendix B Auditing Standard No. 5.

In accordance with paragraph B8 of appendix B Auditing Standard No. 5, in an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting.

Assessment of Risks of Material Misstatement and the Design of Further Audit Procedures

9.38 As discussed previously, risk assessment procedures allow the auditor to gather the information necessary to obtain an understanding of the entity and its environments, including its internal control. This knowledge provides a basis for assessing the risks of material misstatement of the financial statements. These risk assessments are then used to design further audit procedures, such as tests of controls, substantive tests, or both. This section provides guidance on assessing the risks of material misstatement and how to design further audit procedures that effectively respond to those risks.

Assessing the Risks of Material Misstatement

9.39 Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.
- relate the identified risks to what can go wrong at the relevant assertion level.
- consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- consider the likelihood that the risks could result in a material misstatement of the financial statements.

9.40 The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the assessment of the risks of material misstatement at the relevant assertion level as the basis to determine the nature, timing, and extent of further audit procedures to be performed.

Identification of Significant Risks

9.41 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement, including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. In the construction industry, auditors may find that a significant risk exists with regards to the accuracy of management's estimates of costs to complete for contracts in progress. Another example of a significant risk area may include contract revenues due to the possible effects of unsigned or unpriced change orders and claims. The auditor's understanding of the contractor's controls for such significant risks includes, for example, whether control activities (such as a review of estimates and contract prices by senior management and the existence of formal processes for compiling estimates) have been implemented to address the significant risks. Refer to paragraphs .46 and .53 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), for further audit procedures pertaining to significant risks.

Designing and Performing Further Audit Procedures

9.42 AU section 318 provides guidance about implementing the third standard of field work, as follows: "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit."

9.43 To reduce audit risk to an acceptably low level, the auditor (*a*) should determine overall responses to address the assessed risks of material misstatement at the financial statement level and (*b*) should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the assessed risks. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor and should be based on the auditor's assessment of the risks of material misstatement.

Overall Responses

9.44 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence, assigning more experienced staff or those with specialized skills or using specialists, providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed. Additionally, the auditor may make general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, by performing substantive procedures at period end instead of at an interim date.

Further Audit Procedures

9.45 Further audit procedures provide important audit evidence to support an audit opinion. These procedures consist of tests of controls and substantive tests. The nature, timing, and extent of the further audit procedures to be performed by the auditor should be based on the auditor's assessment of risks of material misstatement at the relevant assertion level.

9.46 In some cases, an auditor may determine that performing only substantive procedures is appropriate. However, the auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

9.47 The auditor should perform tests of controls when the auditor's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level. When, in accordance with paragraph .117 of AU section 314, the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion.

9.48 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

9.49 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

9.50 The discussion of tests of controls relates only to those aspects of a contractors internal control that relate to the relevant assertions that are likely to prevent or detect a material misstatement in the account balances, classes of transactions, and disclosure components of the financial statements. The preceding chapter outlines desirable components of internal control for, among other things, estimating and bidding, billings, contract costs, and contract revenues. Some of those controls may not be relevant to an audit and, therefore, need not be considered by the auditor. The auditor considers only those aspects of internal control that relate to the relevant assertions that are

likely to prevent or detect a material misstatement in the account balances, classes of transactions, and disclosure components of the financial statements.

9.51 Tests of controls consist of procedures, such as inquires of appropriate entity personnel; observation of the application of the control; inspection of documents, reports, or electronic files indicating performance of the control; and reperformance of the application of the control by the auditor. AU section 350, *Audit Sampling* (AICPA, *Professional Standards*),[4] provides guidance on the use of audit sampling in audits conducted in accordance with GAAS or PCAOB standards. That guidance may be useful to auditors in determining the extent of tests of controls.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, refer to paragraph 54 of Auditing Standard No. 5 regarding extent of tests of controls.

9.52 Substantive procedures are performed to detect material misstatements at the relevant assertion level and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures. The auditor should plan and perform substantive procedures to be responsive to the related assessment of the risks of material misstatement.

9.53 Regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure.

9.54 The auditor's substantive procedures should include the following audit procedures related to the financial statement reporting process:

- Agreeing the financial statements, including their accompanying notes, to the underlying accounting records
- Examining material journal entries and other adjustments made during the course of preparing the financial statements

The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the entity's financial reporting system and the associated risks of material misstatement.

Evaluating Misstatements

9.55 Based on the results of substantive procedures, the auditor may identify misstatements in accounts or notes to the financial statements. Paragraph .42 of AU section 312 states that auditors must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management. AU section 312 further states that auditors must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. This consideration includes, among other things, the effect of misstatements related to prior periods.

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[4] Refer to the AICPA Audit Guide *Audit Sampling*, which provides guidance to help auditors apply audit sampling in accordance with AU section 350, *Audit Sampling* (AICPA, *Professional Standards*). This guide may be used both as a reference source for those who are knowledgeable about audit sampling and as initial background for those who are new to this area.

9.56 For detailed guidance on evaluating audit findings and audit evidence, refer to AU section 312 and AU section 326, respectively.

Audit Documentation

9.57 Audit documentation is an essential element of audit quality. The form, content, and extent of audit documentation depends on the circumstances of the particular audit engagement and the audit methodology and tools used. The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. The quantity, type, and content of audit documentation are matters of the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), provides requirements about the content, ownership, and confidentiality of audit documentation. Paragraph .03 of AU section 339 states that audit documentation

- provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with GAAS.
- provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

9.58 Moreover, paragraph .10 of AU section 339 states that the auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand (*a*) the nature, timing, and extent of auditing procedures performed to comply with Statements on Auditing Standards (SASs) and applicable legal and regulatory requirements, (*b*) the results of the audit procedures performed and the audit evidence obtained, (*c*) the conclusions reached on significant matters, and (*d*) that the accounting records agree or reconcile with the audited financial statements or other audited information. In documenting the nature, timing, and extent of audit procedures performed, the auditor should record who performed the work and the date such work was completed. Additionally, it should be clear from the audit documentation who reviewed specific elements of the audit work performed and the date of such review. Audit documentation requirements contained in other SASs can be found in appendix A of AU section 339.

9.59 The auditor should complete the assembly of the final audit file on a timely basis, but within 60 days following the report release date (documentation completion date). Statutes, regulations, or the audit firm's quality control policies may specify a shorter period of time in which this assembly process should be completed. After the documentation completion date, the auditor must not delete or discard audit documentation before the end of the specified retention period (generally not fewer than 5 years from the report release date but statutes, regulations, or the firm's quality control policies may specify a longer retention period). When the auditor finds it necessary to make an addition (including amendments) to audit documentation after the documentation completion date, the auditor should document the addition in accordance with paragraph .26 of AU section 339.

9.60 Paragraph .23 of AU section 339 states that the auditor's report should not be dated earlier than the date on which the auditor has obtained

sufficient appropriate audit evidence to support the opinion. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them. This will ordinarily result in a report date that is close to the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements (report release date). Delays in releasing the report may require the auditor to perform additional procedures to comply with the requirements of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*).

9.61 For audits of issuers, PCAOB Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), establishes general requirements for documentation the auditor should prepare and retain in connection with any engagement conducted in accordance with auditing and related professional practice standards of the PCAOB. Such engagements include an audit of financial statements, an audit of internal control over financial reporting, and a review of interim financial information. Auditing Standard No. 3 states that accounting firms must retain documentation prepared in connection with engagements conducted pursuant to the PCAOB standards for seven years unless a longer period of time is required by law.

Considerations for Audits Performed in Accordance With PCAOB Standards

Paragraph 6 of Auditing Standard No. 3 states that the auditor must document the procedures performed, evidence obtained, and conclusions reached with respect to relevant financial statement assertions. Relevant financial statement assertions are described in paragraphs 28–33 of PCAOB Auditing Standard No. 5.

PCAOB Ethics and Independence Rule 3526 requires CPA firms to present—in writing—all relationships it has with a potential client that may bear on independence to a company's Audit Committee before accepting the engagement. Further, Rule 3526 requires CPA firms, on an annual basis, to present—in writing—all relationships it has with a current client that may bear on independence to a company's Audit Committee.

PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), requires auditors to perform an engagement quality review (EQR) for each audit engagement and each interim review engagement. EQRs require a second partner to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the audit or review engagement to determine whether to provide concurring approval of issuance. Auditing Standard No. 7 details who may perform an EQR and details the documents and conclusions required to be reviewed. Consistent with Auditing Standard No. 3, the PCAOB requires that documentation of an EQR should contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the procedures performed by the engagement quality reviewer.

Identifying and Evaluating Control Deficiencies

9.62 In an audit of the financial statements of a nonissuer, the auditor is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of control deficiencies while obtaining an understanding of the entity's internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risk, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of control deficiencies varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.

9.63 The auditor must evaluate identified control deficiencies and determine whether these deficiencies, individually or in combination, are significant deficiencies or material weaknesses (as defined in AU section 325). The significance of a control deficiency depends on the potential for a misstatement, not on whether a misstatement actually has occurred. Accordingly, the absence of identified misstatements does not provide evidence that identified control deficiencies are not significant deficiencies or material weaknesses. When evaluating whether control deficiencies, individually or in combination, are significant deficiencies or material weaknesses, the auditor should consider the likelihood and magnitude of misstatement. Refer to AU section 325 for further guidance on evaluating control deficiencies and chapter 11 for guidance related to communicating internal control related matters identified in an audit.

Auditing Fair Value Measurements and Disclosures

9.64 Financial statements of construction contractors contain a number of significant fair value measurements and disclosures. For example, fair value of investments in nonpublicly-traded entities, such as joint ventures, limited liability companies, and family limited partnerships are common to contractors. Auditing the valuation of investments in nonpublicly-traded entities is an area that requires the use of professional judgment to evaluate whether the entity's method of measurement is appropriate in the circumstances. AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures.

9.65 AU section 328 provides overall guidance on auditing fair value measurements and disclosures. It does not, however, provide guidance on auditing specific assets, liabilities, components of equity, transactions, or industry-specific practices. Other sources of existing authoritative guidance include

- other standards, such as AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).
- Interpretation No. 1, "Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value," of AU section 328 (AICPA, *Professional Standards*, AU sec. 9328 par. .01–.04).
- Interpretation No. 1, "Auditing Investments in Securities Where a Readily Determinable Fair Value Does Not Exist," of AU section 332 (AICPA, *Professional Standards*, AU sec. 9332 par. .01–.04).

9.66 Under AU section 328, the auditors' substantive tests of fair value measurements involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) examining subsequent events and transactions that confirm or disconfirm the estimate.[5]

9.67 When testing management's significant assumptions, the valuation model, and the underlying data, the auditor evaluates whether

- management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
- the fair value measurement was determined using an appropriate model, if applicable.
- management used relevant information that was reasonably available at the time.

Even using the work of a specialist in auditing fair value measurements, the auditor should obtain an understanding of the assumptions and methods used. If the auditor believes the findings are unreasonable, he or she should apply additional procedures as provided in AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*).

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[5] As provided in paragraph .41 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), events and transactions that occur after the balance sheet date but before the date of the auditor's report may provide audit evidence regarding management's fair value measurements as of the balance sheet date.

Chapter 10

Major Auditing Procedures for Contractors[*]

10.01 This chapter provides guidance on the major auditing procedures applicable to financial statement audits of construction contractors. The areas discussed are job site visits, accounts receivable, liabilities related to contracts, contract costs, income recognition, and review of backlog on existing contracts. As discussed in chapter 9, "Planning the Audit, Assessing and Responding to Audit Risk and Additional Auditing Considerations," the nature, timing, and extent of these procedures should be responsive to the assessed risks of material misstatement at the relevant assertion level. In accordance with AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), certain substantive procedures should be performed on all engagements. These procedures include

- performing substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure regardless of the assessed risks of material misstatement;
- agreeing the financial statements, including their accompanying notes, to the underlying accounting records; and
- examining material journal entries and other adjustments made during the course of preparing the financial statements.

Job Site Visits and Interim Audit Procedures

10.02 In certain situations, job site visits are essential for the auditor to understand the contractor's operations and to relate the internal accounting information to events that occur at the job sites. All or part of the accounting function relating to a given project may be performed at a temporary job site office staffed by a limited number of trained accounting personnel, and internal control at job sites may be ineffective. Observations and discussions with operating personnel at the job sites may also assist the auditor in assessing physical security, the status of projects, and the representations of management (for example, representations about the stage of completion and estimated costs to complete). The auditor should consider using specialists, such as outside engineering consultants, in performing job site audit procedures. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance and establishes requirements in this area. Job site visits assist the auditor in meeting the following five objectives:

- Gaining an understanding of the contractor's method of operations
- Determining that the job actually exists
- Obtaining information from field employees to corroborate the information obtained from management, including whether employees at the job site are the same ones whose time is charged to the job

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[*] Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

- Obtaining an understanding of those components of internal control maintained at the job site
- Obtaining information relating to job status, including whether materials charged to the job have been installed, and problems (if any) that may be useful in other phases of the audit

10.03 These objectives can usually be achieved during one visit to a job site. To do so, however, requires careful planning so that the information to be obtained or examined will be identified before the visit. Furthermore, to meet the third objective, it is usually desirable, before selecting the job sites to be visited, to consider (*a*) the contractor's internal control; (*b*) the size, nature, significance, and location of projects; and (*c*) projects that have unusual features or that appear to be troublesome. Unusual or troublesome contracts may include those accounted for under the percentage-of-completion method on the basis of estimates in ranges, or on the basis of zero profit estimates, those that are combined or segmented for accounting purposes, and those with significant unpriced change orders or unsatisfied claims, all of which are discussed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35.

10.04 Other characteristics of troublesome contracts may include those that have significant profit fades from the prior interim or annual period, those that have a significant underbilling, and those subject to unusual risks because of factors such as location, ability to complete turnkey projects satisfactorily, postponement or cancellation provisions, or disputes between the parties.

10.05 To accomplish audit objectives, job site visits may be made at any time during the year or at the end of the year. When considering obtaining audit evidence about the effectiveness of internal controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period. In making this determination, the auditor should consider the significance of the assessed risks of material misstatement at the relevant assertion level. Factors that support the risk assessment may include the design, implementation, and effectiveness of internal control; the number, size, and significance of projects; the existence of projects with unusual or troublesome features; and the method of accounting for revenue. However, if the contractor's internal control is inadequate and if the contractor has in progress any large projects that individually have a material effect on the contractor's results of operations or any projects that have unusual features or that appear to be troublesome, the auditor should select those projects for visits at or near the year-end. The auditor should also consider the length of the remaining period, the extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls, and the control environment. Further guidance concerning the timing of tests of controls in connection with the audit of financial statements is provided in paragraphs .37–.45 of AU section 318.

10.06 AU section 318 provides guidance and establishes requirements for applying principal substantive tests at an interim date. The higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). Further guidance concerning the

timing of substantive procedures is also provided in paragraphs .58–.65 of AU section 318.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*[†]
>
> When performing an integrated audit, refer to paragraphs 52–53 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding timing of tests of controls.

10.07 In addition to obtaining an understanding of the entity and its environment, including its internal control and performing tests of the accounting records, the independent auditor might consider performing the following procedures during a job site visit:

- Observation of uninstalled materials
- Observation of work performed to date
- Observation of contractor-owned or rented equipment
- Discussions with project managers, superintendents, and other appropriate individuals, including, if possible, the independent architect, regarding the status of the contract and any significant problems

Job site visits facilitate the auditor's collection of information concerning the organization and management of the job, the accounting reports submitted to the general accounting office, the present status of the job, and unusual matters affecting the estimated costs to complete the project.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, refer to paragraphs B10–B16 of appendix B, "Special Topics," of Auditing Standard No. 5 for discussion of considerations when an entity has multiple locations or business units.

Accounts Receivable

10.08 The general approach to the audit of a construction contractor's accounts receivable is similar to that followed in the audit of accounts receivable of industrial and commercial enterprises. AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*), provides guidance about the confirmation process in audits performed in accordance with generally accepted auditing standards (GAAS) or PCAOB standards. The auditor confirms accounts receivable, including retentions. The confirmation ordinarily contains

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[†] In August 2010, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). With this release, the PCAOB adopted eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the board's interim auditing standards and related amendments to PCAOB standards. These standards are effective for audit engagements conducted pursuant to the standards of the PCAOB for fiscal years beginning on or after December 15, 2010. Refer to the preface of this guide for important information about the release and applicability of these standards. Readers can download the entire release, which includes full text of the standards, at http://pcaobus.org/.

other pertinent information, such as the contract price, payments made, and status of the contract. Exhibit 10-1 is a sample confirmation letter requiring positive confirmation. Negative confirmations may also be used, provided the conditions described in paragraph .20 of AU section 330 exist.[1]

10.09 Certain characteristics of a construction contractor's accounts receivable, such as the following, may require special audit consideration:

- Unbilled receivables
- Retentions
- Unapproved change orders, extras, and claims
- Contract scope changes
- Contract guarantees and cancellation or postponement provisions
- Collectibility

Other characteristics that may require special audit consideration include approved but unpriced change orders and government contracts under which the contractor proceeds with all phases of the contract even though government funding is approved piecemeal.

Unbilled Receivables

10.10 Unbilled receivables arise when revenues have been recorded, but the amount cannot be billed under the terms of the contract until a later date. Specifically, such balances may represent (*a*) unbilled amounts arising from the use of the percentage-of-completion method of accounting, (*b*) incurred cost to be billed under cost-reimbursement-type contracts, or (*c*) amounts arising from routine lags in billing (for example, for work completed in one month but not billed until the next month). It may not be possible to confirm those amounts as receivables directly with the customer; consequently, the auditor should apply alternative audit procedures, such as the subsequent examination of the billing and collection of the receivables and evaluation of billing information on the basis of accumulated cost data.

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[1] Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, AU sec. 9330 par. .01–.08), clarifies, among other matters, that the use of an electronic confirmation process is not precluded by AU section 330. Although no confirmation process with a third party is without some risk of interception or alteration, including the risk that the confirmation respondent will not be the intended respondent, paragraph .05 of the interpretation states that confirmations obtained electronically can be considered to be reliable audit evidence if the auditor is satisfied that (*a*) the electronic confirmation process is secure and properly controlled, (*b*) the information obtained is a direct communication in response to a request, and (*c*) the information is obtained from a third party who is the intended respondent. The interpretation also provides guidance to assist the auditor in assessing the risks related to the reliability of the information received electronically.

Exhibit 10-1

Sample Confirmation Request to Owner, General Contractor, or Other Buyer

Re: [*Description of Contract*]

Gentlemen:

Our independent auditors, [*name and address*], are engaged in an audit of our financial statements. For verification purposes only, would you kindly respond directly to them about the accuracy of the following information at [*date*]:

1. Original contract price $______
2. Total approved change orders $______
3. Total billings $______
4. Total payments $______
5. Total unpaid balance $____including retentions of $_____
6. Details of any claims, back charges, or disputes concerning this contract (attach separate sheet if necessary)
7. Estimated completion date ______
8. Estimated percent complete ______

We have enclosed a self-addressed, stamped envelope for your convenience in replying directly to our auditors. Your prompt response will be greatly appreciated.

Very truly yours,

Enc.

The above information is:

( ) Correct

( ) Incorrect (please submit details of any differences)

By:

____________________________________ ________________

Signature Date

____

Title

Retentions

10.11 The contractor's accounting records ordinarily should provide for separate control for retentions because they are generally withheld until the contract is completed and, in certain instances, for even longer periods. They may also be subject to restrictive conditions, such as fulfillment guarantees. The auditor should test retentions as part of performing further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. Relevant assertions are assertions that have a meaningful bearing on whether the account is fairly

stated. For example, the completeness assertion is relevant to retentions in that it relates to whether all retentions are recorded, but the valuation assertion may not be relevant.

Unapproved Change Orders and Claims

10.12 Unapproved change orders and claims are often significant and recurring in the construction industry, and receivables arising from those sources may require special audit consideration. Paragraphs 25–31 of FASB ASC 605-35-25 set forth the circumstances and conditions under which amounts may be recorded as revenue from unapproved change orders and claims. Because of the nature of those receivables, the auditor may encounter difficulties in evaluating their propriety or the collectibility of the related additional revenue. The auditor may be able to confirm the amounts of unapproved change orders or claims with customers; however, if confirmation is not possible or if the amounts are disputed, the auditor should obtain evidence to evaluate the likelihood of settlement on satisfactory terms and the collectibility of the recorded amounts. The auditor might consider how the contractor has historically collected on its unapproved change orders. For example, if historically the contractor does not get the ultimate approval for a change order, or if it is approved for an amount less than what is expected by management, the auditor should consider this when determining the reasonableness of the current and pending change orders. To determine whether the conditions specified in FASB ASC 605-35 to record a receivable have been met, the auditor should review the terms of the contract and should document the amounts by discussions with the contractor's legal counsel and with contractor personnel who are knowledgeable about the contract.

10.13 When unapproved change orders and claims are the basis for significant additional contract revenues, or are otherwise identified for testing as part of the auditor's consideration of substantive procedures to perform, the auditor should evaluate the propriety of accumulated costs underlying the unapproved change orders. The following are some of the procedures that may be used in auditing such accumulated costs:

- Tests of the accumulation of costs to underlying invoices, time records, and other supporting documentation. In some circumstances, confirmation of relevant data and related amounts with subcontractors and others may be feasible.
- Consideration of whether the work performed or costs incurred were authorized in writing by the customer. If not, additional contract revenues may not be billable, and the costs may not be recoverable.
- Evaluation of whether the costs relate to work within or outside the scope of the contract. If the costs relate to work within the scope of a lump-sum contract, no basis for additional contract revenues may exist, and the costs may not be recoverable.

10.14 The auditor might also evaluate the nature and reasonableness of claimed damages that are attributable to customer-caused delays, errors in specifications that caused incorrect bids, or various other reasons. In connection with such an evaluation, the auditor should consider the quality and extent of the documentary evidence supporting the claim and the extent to which management has pursued the claim; the auditor also should consider consultation with technical personnel. It may also be appropriate to obtain an opinion from

legal counsel (*a*) on the contractor's legal right to file such a claim against the customer, and (*b*) on the contractor's likelihood of success in pursuing the claim.

10.15 A claim may be properly supported, but, nevertheless, may be uncollectible. Many factors influence collectibility, including the relationship between the contractor and the customer. For example, a contractor may be less likely to press for collection of a claim from a major customer. In evaluating a claim, the auditor may consider the contractor's past experience in settling similar claims. If, for example, the contractor has demonstrated a reasonable degree of success in negotiating and settling similar types of claims and if the documentation supporting a claim under review appears to be similar in scope, depth, and content, the auditor may consider such prior experience in evaluating the collectibility of the claim. The auditor's use of heightened skepticism is warranted toward claims for which the contractor cannot provide collaborative evidence to support but rather are recorded based solely on management's feel or estimate.

Contract Scope Changes

10.16 Scope changes on contracts, particularly cost-plus contracts, are often not well documented. Large cost-plus contracts frequently evolve through various stages of design and planning, with numerous starts and stops on the part of both the customer and the contractor. As a result, the final scope of the contract is not always clearly defined. The auditor should carefully examine costs designated to be passed through to the customer under such contracts and should determine whether the costs are reimbursable or whether they should be absorbed by the contractor as unreimbursable contract costs. If receivables arise from contract scope changes that are unapproved or disputed by customers, the previous discussion on claims applies.

Contract Guarantees and Cancellation or Postponement Provisions

10.17 Many contracts provide for contract guarantees, such as a guarantee that a power plant, when completed, will generate a specified number of kilowatt hours. A contract may specify a fixed completion date, which, if not met, may result in substantial penalties. For some contracts, retentions and their ultimate realization are related to the fulfillment of contract guarantees. The auditor should carefully read the contracts to identify guarantees or contingencies associated with a project to determine whether the contractor has given adequate consideration to the cost of fulfilling contract guarantees.

10.18 In addition, the auditor should carefully read the contracts to identify cancellation and postponement provisions associated with a project. Effective internal procedures provide for the contractor's timely notification to subcontractors of contracts cancelled or postponed in order to minimize problems and the possibility of litigation.

10.19 Cancelled or postponed contracts may be identified in the contractor's records or may be disclosed in other ways during the audit. For example, the auditor's confirmation procedures may disclose cancelled or postponed contracts. The auditor should then satisfy himself or herself that the open balance of accounts receivable, which may in effect be a claim, is valid and collectible.

10.20 For a contract that has been cancelled, the auditor should evaluate the contractor's right and ability to recover costs and damages under the

contract. If the amounts that the contractor seeks to recover under the contracts are in dispute, the auditor should evaluate them as claims in accordance with the previous discussion on claims.

10.21 For contracts that have been postponed, the auditor should evaluate whether the estimated cost to complete is documented and reflects inflationary factors that may cause costs to increase because of the delay in the performance of the contract. The auditor should consider the reason for postponement and its ultimate implications because a postponement could ultimately lead to a cancellation with attendant problems relating to the recoverability of costs. In this area of the audit, the auditor should consider consultation with legal counsel in evaluating the client's contractual rights.

Collectibility

10.22 As work progresses on the contract, construction contractors may experience problems relating to the collectibility of receivables that differ from those found in industrial and commercial entities. Problems may result from the long period of the contract, the size of the contract, the possibility for disputes, the type of financing the customer has arranged, or the current economic environment. The contractor ordinarily should evaluate whether the customer has financial substance or has made financing arrangements through a third party with financial substance. The auditor might review the contractor's determination and also consider performing such auditing procedures as a review of financial statements of the customer or a review of the financing arrangements entered into by the customer with a third party, even though there may be no apparent indication that the receivable might not be collectible.

10.23 In the evaluation of the ability of the customer to satisfy his obligations, the auditor should also consider the stage of completion of the contract, the past payment performance of the customer, and the amount of the contract price yet to be billed under the contract—not solely the customer's ability to remit the year-end outstanding balance. In the event of indications that a customer may be unable to pay the contractor, the auditor should consider the extent to which bonding arrangements and lien rights will limit possible losses by the contractor. The auditor should consider whether lien rights have been filed to protect the contractor's rights. Some of the information obtained in the evaluation of collectibility may be useful in the audit of amounts recognized as income on the contract.

Liabilities Related to Contracts

10.24 The auditor should satisfy himself or herself that liabilities include not only amounts currently due but also retained percentages that apply to both subcontractors and suppliers who bill the contractor in that manner. The auditor might request confirmation of balances, as well as other relevant information, from specific suppliers and subcontractors. Exhibit 10-2 is a suggested confirmation form for subcontractors.

Exhibit 10-2

Sample Confirmation Request to Subcontractor

Gentlemen:

Our independent auditors, [*name and address*], are engaged in an audit of our financial statements. For verification purposes only, would you kindly submit directly to them the following information with respect to each (or specific) contract(s) in force at [*date*]:

1. Original contract price $
2. Total approved change orders $
3. Total billings $
4. Total payments $
5. Total unpaid balance, including retentions $
6. Total retentions included in total balance due $
7. Total amount and details of pending extras and claims in process of preparation, if any (attach separate sheet if necessary) $
8. Estimated completion date $

We have enclosed a self-addressed, stamped envelope for your convenience in replying directly to our auditors. Your prompt response will be greatly appreciated.

Very truly yours,

Enc.

10.25 The auditor should satisfy himself or herself that the contractor has made a proper cutoff and that all costs, including charges from subcontractors, have been recorded in the correct period. The auditor should also perform audit procedures to test whether charges by subcontractors are in accordance with the terms of their contracts and the work performed by the subcontractor and are not simply advances that may be allowable under contract terms. The amounts billable by a subcontractor under the terms of a contract is the amount that should be recorded in accounts payable; however, the actual work performed on the job represents the amount that should be recorded as allowable cost in determining the extent of progress toward completion. In reviewing liabilities, it is essential that the auditor be alert for indications of claims and extras that may be billed by the subcontractor. The review may also disclose amounts that should be accounted for as back charges to the subcontractor under the terms of the contract.

10.26 All invoices for services rendered should be recorded as accounts payable even though the amount may not be used in measuring the performance to date on the contract. The auditor should satisfy himself or herself that the contractor has not included amounts not used in measuring performance in both the cost incurred to date and the estimated cost to complete.

10.27 The auditor should review older invoices and retentions included in accounts payable for an indication of defective work, failure on performance guarantees, or other contingencies that may not have been recorded on the contractor's records or included in the estimated cost to complete.

10.28 Under the Uniform Commercial Code (UCC), financial institutions and other creditors often file a notice of a security interest in personal property on which they have advanced credit. Notices may be filed with both the state and

county in which the property is located. The auditor should consider sending UCC inquiry forms to states and counties in which the contractor has significant jobs. Such inquiries may disclose unrecorded liabilities and security interests, as defined in the UCC.

Contract Costs

10.29 The auditing of contract costs involves two primary areas: the accumulated costs to date and the estimated cost to complete. The auditor is reminded that in the audit of a contractor, the emphasis is on the contract and the proper recording of contract revenues and costs. The determination of the accuracy of both the costs incurred to date and the estimated costs to complete is necessary for each contract in order to determine whether the gross profit on a contract is recognized in conformity with generally accepted accounting principles.

10.30 Income for a contractor is determined by the ultimate profit or estimated profit on each contract and is not based on the billings to date or the cost incurred to date. Under the completed-contract method, profit recognition is deferred until the contract is substantially completed; therefore, the cost incurred to date on uncompleted contracts is not reflected in the determination of current income unless a loss on the contract is anticipated. Conversely, the percentage-of-completion method requires that projected gross profit on the contract be estimated before the gross profit for the period under audit can be determined.

10.31 The audit considerations concerning both the accumulated cost to date and the estimated cost to complete are discussed in this section.

Costs Incurred to Date

10.32 The auditor should satisfy himself or herself that the contractor has properly recorded costs incurred to date by contract. The auditor should satisfy himself or herself that the contractor has included in accumulated contract costs identifiable direct and indirect costs and an acceptable and consistent allocation of overhead to specific contracts. For cost-plus contracts, the auditor should satisfy himself or herself that the contractor has not recognized contract revenue based on unreimbursable contract costs. The extent of substantive testing will depend on the auditor's assessment of the risks of material misstatement, as discussed in chapter 9.

Estimated Cost to Complete

10.33 One of the most important phases of the audit of a construction contractor relates to estimated costs to complete contracts in process because that information is used in determining the estimated final gross profit or loss on contracts. Estimated costs to complete involve expectations about future performance, and the auditor should (*a*) critically review representations of management, (*b*) obtain explanations of apparent disparities between estimates and past performance on contracts, experience on other contracts, and information gained in other phases of the audit, and (*c*) document the results of work in these areas. Because of the direct effect on the estimated interim and final gross profit or loss on the contract, the auditor should evaluate whether the contractor's estimate of cost to complete is reasonable. AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), provides guidance

to auditors on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements in accordance with GAAS or PCAOB standards.

10.34 The information that the auditor should consider using in the review of estimated costs to complete includes the following:

- The auditor's knowledge of internal control, with particular emphasis on the auditor's assessment of the risks of material misstatement in areas such as estimating and bidding; project management and contract evaluation; contract costs; and claims, extras, and back charges, including a summary of the results of internal audits and a discussion of the contractor's historical experience.
- A comparison of costs incurred to date plus estimated cost to complete with the original bid estimate, along with explanations of unusual variances and changes in trends.
- A summary of work performed to determine that actual or expected contract price and estimated costs to complete include price and quantity increases, penalties for termination or late completion, warranties or contract guarantees, and related items.
- A review of project engineers' reports and interim financial data, including reports and data issued after the balance sheet date, with explanations for unusual variances or changes in projections. Of particular importance would be a review of revised or updated estimates of cost to complete and a comparison of the estimates with the actual costs incurred after the balance sheet date.
- A review of information received from customers or other third parties in confirmations and in conversations about disputes, contract guarantees, and so forth that could affect total contract revenue and estimated cost to complete.
- Discussions with the contractor's engineering personnel and project managers who are familiar with, and responsible for, the contract in process.
- A review of the reports of independent architects and engineers.
- A review of information received from the contractor's attorney that relates to disputes and contingencies.
- Analytical procedures,[2] including comparing prior year's estimates with subsequent actual results and determining the reasonableness of the estimated gross profit percentage as compared to jobs completed during the current fiscal period.

10.35 Not all of the previously listed types of evidence are available for all audits of all construction contractors. The auditor should consider the sufficiency and appropriateness of each type of evidence in forming an opinion. The auditor's objective is to test the overall reasonableness of the estimated cost to

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[2] Refer to the AICPA Audit Guide *Analytical Procedures*, which provides guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This includes a discussion of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), and the underlying concepts and definitions, a series of questions and answers, an illustrative case study, and an appendix that includes useful financial ratios.

complete in the light of the information obtained from those and other available sources.

Income Recognition

10.36 The amount and timing of income recognized from contracts depend primarily on the methods and bases used to account for those contracts, including those contracts that may be combined or segmented in accordance with the paragraphs that follow. The auditor should satisfy himself or herself that contracts are accounted for in accordance with FASB ASC 605-35, and that the guidance is applied consistently to all like contracts and in all periods. To form an opinion on the reasonableness of the amount and timing of income recognized, the auditor should obtain an overview of costs and revenues by contract.

10.37 As a result of the technological complexity or the nature of the contractor's work, the auditor might use the work of independent specialists, such as engineers, architects, and attorneys, to obtain audit evidence in various phases of the audit. For example, on some complex contracts, the auditor might use a specialist to evaluate the percentage of completion or the estimated cost to complete. AU section 336 provides guidance in this area.

10.38 Anticipated losses on contracts, including contracts on which work has not started, should be recognized in full at the earliest date at which they are determinable. In addition, the contractor ordinarily should consider the need to recognize other contract costs or revenue adjustments, such as guarantees or warranties, penalties for late completion, bonuses for early completion, unreimbursable costs under cost-plus contracts, and foreseeable losses arising from terminated contracts.

Evaluating the Acceptability of Income Recognition Methods

10.39 Paragraphs 1–2 of FASB ASC 605-35-25 provide guidance for evaluating the acceptability of a contractor's basic policy for income recognition. The audit procedures described in this and the preceding chapter are closely interrelated, and together they assist the auditor in satisfying himself or herself in regard to the acceptability of the method of income recognition and the bases of applying that method. The procedures include all those previously discussed (review of contracts; understanding the entity and its environment, including its internal control, particularly as it relates to costs and contract revenues; job site visits; and procedures applied in the audit of receivables, liabilities related to contracts, and contract costs) and the procedures discussed in this section on income recognition.

10.40 In evaluating the acceptability of the accounting method used by a contractor, the auditor should satisfy himself or herself that the contractor has followed the guidance in FASB ASC 605-35-25-57, which states that the use of the percentage-of-completion method as the basic accounting policy is considered preferable when reasonably dependable estimates can be made, and the contracts meet all the conditions specified. If contracts meet those conditions, FASB ASC 605-35-25-58 states that the presumption is a contractor has the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Normally, as provided in FASB ASC 605-35-25-60, estimates of total contract revenue and total contract cost in single amounts should be used as the basis of accounting for

contracts under the percentage-of-completion method. However, estimates based on ranges of amounts or on a breakeven or zero-profit basis are acceptable in circumstances described in FASB ASC 605-35-25-60. The auditor should satisfy himself or herself that the aforementioned guidance has been reasonably applied.

10.41 Paragraphs 79–81 of FASB ASC 605-35-25 discuss the considerations that should underlie the selection of a method of measuring the extent of progress toward completion under the percentage-of-completion method. The auditor should evaluate the methods used by the contractor in accordance with those considerations.

10.42 In evaluating the acceptability of the percentage-of-completion method as a contractor's basic accounting policy, as well as the acceptability of the basis used to measure the extent of progress toward completion, the auditor should consider procedures such as the following:

- Reviewing a selected sample of contracts to evaluate whether the contracts meet the basic conditions in FASB ASC 605-35-25-57 for use of the percentage-of-completion method
- Obtaining, reviewing, and evaluating documentation of estimates of contract revenues, costs, and the extent of progress toward completion for the selected sample of contracts
- Consulting, if necessary, with independent engineers or independent architects
- Obtaining and reviewing a representative sample of completed contracts to evaluate the quality of the contractor's original and periodic estimates of profit on those contracts
- Obtaining a representation from management on the acceptability of the method

10.43 If the contractor applies the percentage-of-completion method on the basis of estimates in terms of ranges or in terms of zero profit for any contracts, the auditor should obtain separate schedules for contracts accounted for on each of those bases and for contracts initially reported on those bases but changed to the normal basis during the period. For contracts in each of those categories, the auditor should consider the following procedures in evaluating the acceptability of those approaches to applying the percentage-of-completion method:

- For a selected sample of such contracts, obtaining documentation from management of the circumstances justifying the approaches
- Discussing with management personnel and, if necessary, independent architects and engineers the reasonableness of the approaches used for the sample of contracts selected in each category
- Obtaining representation from management on the circumstances justifying each of the approaches

10.44 Paragraphs 90–93 of FASB ASC 605-35-25 describe the appropriate circumstances for use of the completed-contract method as the basic accounting policy. When the lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable. The completed-contract method may also be used as an entity's basic accounting policy in circumstances in which financial position and results of operations

would not vary materially from those resulting from use of the percentage-of-completion method (for example, in circumstances in which an entity has primarily short-term contracts).

10.45 In evaluating whether the circumstances in the preceding paragraph exist, the auditor should consider the use of procedures such as the following:

- Reviewing the nature of the contractor's contracts and the period required to perform them
- Obtaining a schedule of uncompleted contracts at the beginning and end of the period and evaluating whether the volume is significant in relation to the volume of contracts started and completed during the period
- Estimating the effect of reporting on the percentage-of-completion basis and evaluating whether the results would produce a material difference in financial position or results of operations

The Percentage-of-Completion Method

10.46 The auditor's objective in examining contracts accounted for by the percentage-of-completion method is to determine that the income recognized during the current period is based on (*a*) the total gross profit projected for the contract on completion and (*b*) the work performed to date. The total gross profit expected from each contract is derived from an estimate of the final contract price less the total of contract costs to date and estimated cost to complete. The auditor tests those components in connection with other auditing procedures previously discussed.

10.47 The auditor should satisfy himself or herself that, in relation to the nature of the contract, the method selected and used by the contractor to measure progress (such as measures based on architectural or engineering estimates, cost-to-cost, labor hours, machine hours, or units produced) produces a reasonable measurement of the work performed to date. Information obtained from job site visits may be particularly useful in reviewing costs incurred to date when the cost-to-cost method is used. Such information may point out the need to disregard certain costs (such as advance billings by subcontractors, cost of undelivered materials, or cost of uninstalled materials) in order to measure more accurately the work performed to date. Contract billings to customers may signify the percentage of completion if the contract provisions require that billings be associated with various stages of work performed on the contract.

10.48 The auditor should examine unbilled contract revenues to determine the reasons that they have not been billed. If such revenues relate to change orders or claims, the auditor should evaluate the collectibility of the change orders or claims.

The Completed-Contract Method

10.49 The objectives of the auditor in examining contracts accounted for by the completed-contract method are to determine (*a*) the proper amount and accounting period for recognition of the profit from completed contracts, (*b*) the amount of anticipated losses, if any, on uncompleted contracts to be recognized in the current period, and (*c*) consistency in application of the method of determining completion.

10.50 The auditor should review events, contract costs, and contract billings subsequent to the end of the accounting period to obtain additional assurance that all contract revenues and related costs are included in the period in which the contracts are deemed to be substantially completed for income recognition purposes. As established in FASB ASC 605-35-25-96, a contract may be regarded as substantially completed, as a general rule, if remaining cost and potential risks are insignificant in amount. The overriding accounting objectives are to maintain consistency in determining when contracts are substantially completed and to avoid arbitrary acceleration or deferral of income.

Combining and Segmenting

10.51 Income recognition in a given period may be significantly affected by the combining or segmenting of contracts. In the course of the audit, the auditor may find that contracts have been, or in his or her opinion should have been, combined or segmented. The auditor should, therefore, evaluate the propriety of combining contracts or, conversely, segmenting components of a contract or a group of contracts in accordance with the criteria in paragraphs 3–14 of FASB ASC 605-35-25. In evaluating the propriety of combining a group of contracts and the propriety of segmenting a contract or a group of contracts, the auditor should satisfy himself or herself that the criteria are applied consistently to contracts with similar characteristics in similar circumstances. The auditor should consider procedures such as the following:

- Reviewing combined contracts to determine whether they meet the aforementioned criteria and reviewing a representative sample of other contracts to determine if any other contracts meet those criteria
- Reviewing contracts or groups of contracts that are reported on a segmented basis to determine whether they meet the aforementioned criteria and whether the criteria are applied consistently

Review of Earned Revenue

10.52 For significant contracts, the auditor should obtain and review working paper schedules that summarize contract information from the contractor's books and records together with audit data arising from the audit of contract activity. The schedules are valuable because they permit an orderly analysis of the relationship of costs and revenues on a contract-by-contract basis. Illustrations of such schedules, prepared for fixed-price contracts accounted for by the percentage-of-completion method, are presented in exhibits 10-3–10-4.

10.53 The illustrations are based on the assumption that the contractor determines the stage of completion and adjusts his accounts accordingly. Even so, as demonstrated by the illustrations, the schedules enable the auditor to pinpoint the need for adjustments.

10.54 Similar, although less detailed, schedules should also be considered for significant cost-plus contracts in process and for significant contracts closed during the period.

Analysis of Gross Profit Margins

10.55 Finally, the auditor should consider analyzing gross profit margins on contracts and investigating and obtaining explanations for contracts with unusually high or low profit margins in the light of present and past

experience on similar contracts. The auditor should consider a review of the original estimates of any contracts in question and a comparison of the results on those contracts for the current period with the results of prior periods. Audit procedures performed might include comparison of profit margins recognized on open contracts (with the final results on similar closed contracts) and comparison of the final profit on closed contracts (with the estimated profit on those contracts in the prior year). Similarly, at or near the date of the auditor's report, the auditor should obtain the contractor's most recent interim financial statements and work-in-process analysis to review, among other things, the contractor's most recent cost estimates on contracts not completed at the balance sheet date. Paragraph .03 of AU section 560, *Subsequent Events* (AICPA, *Professional Standards*), states that the financial statements should be adjusted for any changes in estimates resulting from the use of such evidence that have a material effect on the financial statements.

10.56 The auditor should consider maintaining a summary of the historical information (the most recent four to five years, preferably) developed in the analysis for a reference in future audits. As provided in paragraph .24 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), audit evidence obtained from previous audits may provide audit evidence in certain circumstances if the auditor is able to establish its continuing relevance.

Exhibit 10-3

XYZ Company, Inc.
Fixed-Price Contracts in Process
Summary of Original and Revised Contract Estimates
As of Balance Sheet Date

							Revised Estimate of Contract Costs					
Contract Identification	*Original Contract Price*	*Original Estimate of Contract Costs*	*Original Estimate of Gross Profit — Amount*	*Original Estimate of Gross Profit — %*	*Net Changes in Contract Price*	*Revised Contract Price*	*Costs to Date*	*Estimated Costs to Complete*	*Revised Total Costs*	*Revised Estimate of Gross Profit — Amount*	*Revised Estimate of Gross Profit — %*	*% of Completion Measured by*
	(1)	(2)	(2)	(2)	(3)		(4)	(5)				(6)
A	$100,000	$55,000	$45,000	45%	0	$100,000	$42,000	$18,000	$60,000	$40,000	40%	Cost to cost
B	130,000	110,000	20,000	15.4%	20,000	150,000	80,000	40,000	120,000	30,000	20%	Cu.Yds.Completed
C	175,000	125,000	50,000	28.6%	25,000	200,000	125,000	75,000	200,000	0	—	Labor hours
D	250,000	200,000	50,000	20%	150,000	400,000	270,000	330,000	600,000	(200,000)	—	Cost to cost

(1) Per original contract.
(2) Per original bid.
(3) Supported by change orders or claims, or both, meeting accounting criteria for inclusion.
(4) Per audit of contract costs.
(5) Per audit of estimated costs to complete.
(6) Reviewed for appropriateness and consistency.

Exhibit 10-4

XYZ Company, Inc.
Fixed-Price Contracts in Process
Analysis of Contract Status
As of Balance Sheet Date

	Per Contractor's Books and Records						Auditor's Adjustment				Adjusted Gross Profit					
					Gross Profit to Date						To Date		Prior Periods		Current Period	
Contract Identification	*Contract Billings to Date*	*Costs Incurred to Date*	*% Completed*	*Revenue Earned to Date*	*Amount*	*%*	*Revised % Completed*	*Revised Earned Revenue to Date*	*Revenue Adjustments*	*Provision for Projected Loss Adjustments*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
	(1)	(2)	(3)	(4)			(5)	(6)	(7)	(7)	(8)	(8)	(9)	(8)	(8)	(8)
A	$80,000	$42,000	70%	$80,000	$38,000	47.5%	70%	70,000	($10,000) (A)		$28,000	40%	$20,250	45 %	$7,750	31%
B	82,500	80,000	65%	97,500	17,500	17.9%	67%	100,500	3,000 (B)		20,500	20%	8,500	18.9%	12,000	21.6%
C	150,000	125,000	55%	110,000	(15,000)	—	62.5%	125,000	15,000 (C)		0	—	28600	28.6%	(28,600)	—
D	300,000	270,000	45%	300,000	30,000	10%	45%	180,000	(120,000) (A)	110,000 (D)	(200,000)	—	—	—	(200,000)	—

(1) Per audit of contract billings.
(2) Per audit of contract costs.
(3) Management's estimate of completion.
(4) Per contract revenue accounts on books.
(5) Per auditor—based on review and analysis of costs, billings, management's estimate, of completion, job site visits.
(6) Result of applying revised percentage of completion to revised contract price.
(7) Adjustments to be reviewed with and accepted by management.
(8) Should be compared with prior periods and with similar contracts.
(9) Per audit of prior periods.

(A) Adjustment necessary to reduce recorded earned revenue and recognize excess billings.
(B) Adjustment necessary to increase recorded earned revenue and recognize unbilled revenue.
(C) Adjustment necessary to increase recorded earned revenue and reduce recorded excess billings in order to reflect projected "break-even" on contract. Remaining revenue ($75,000) now equals estimated costs to complete.
(D) Adjustment necessary to provide for balance of the total projected loss on contract. Remaining revenue ($220,000) now equals estimated costs to complete ($330,000) less provision for projected loss ($110,000).

Review of Backlog Information on Signed Contracts and Letters of Intent

10.57 The accounting section of this guide encourages contractors to present in the basic financial statements backlog information for signed contracts whose cancellation is not expected, and it suggests that contractors may include additional backlog information on letters of intent and a schedule showing backlog at the beginning of the year, new contracts awarded during the year, revenue recognized during the year, and backlog at the end of the year (see paragraph 6.28, "Backlog on Existing Contracts," in this guide). The presentation of such information helps users of the contractor's financial statements assess the contractor's current level of activity and prospects for maintaining that level of activity in future periods.

10.58 Information on signed contracts whose cancellation by the parties is not expected is within the scope of an audit of the contractor's financial statements. If a contractor elects to present backlog information on signed contracts in addition to in the basic financial statements in an auditor-submitted document, paragraph .06 of AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*),[‡] states that the auditor's report should include, among other things, either an opinion on whether the accompanying information is fairly stated in all material respects in relation to the basic financial statements as a whole or a disclaimer of opinion. Although the auditor has no obligation to apply auditing procedures to information presented outside the basic financial statements, he or she may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements so that he or she may express an opinion on the accompanying information. Such procedures should include a review of the information and an evaluation of its completeness in light of other audit procedures for contract receivables, contract-related liabilities, contract costs, and contract revenues. For that purpose, the auditor should obtain a schedule of all uncompleted signed contracts showing for each contract total estimated revenue, total estimated cost, earned revenue to date, costs incurred to date, and cost of earned revenue.

[‡] In February 2010, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements*; SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*; and SAS No. 120, *Required Supplementary Information*. These SASs amend or supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*; AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*), respectively. Collectively, these statements address the auditor's responsibilities with respect to information that is required by a designated standard setter (specifically, the Financial Accounting Standards Board, Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and the International Accounting Standards Board) to accompany an entity's basic financial statements and supplementary information that is presented outside the basic financial statements. The effective date of the SASs is for audits of financial statements for periods beginning on or after December 15, 2010, and early application is permitted.

Because the effective dates of SAS No. 118, SAS No. 119, and SAS No. 120 are beyond the date of this guide (May 1, 2011), this guide will be updated for SAS No. 118, SAS No. 119, and SAS No. 120 in the next edition. Due to the issuance of SAS No. 118, SAS No. 119, and SAS No. 120, AU sections 550, 551, and 558 (as they existed prior to being superseded) have been moved to AU sections 550A, 551A, and 558A of *Professional Standards*, respectively, until the effective date of SAS No. 118, SAS No. 119, and SAS No. 120. This guide references AU sections 550A, 551A, and 558A as appropriate because SAS No. 118, SAS No. 119, and SAS No. 120 have not been incorporated in this edition.

10.59 If a contractor elects to present backlog information for both signed contracts and letters of intent and the auditor intends to express an opinion on this accompanying information, the auditor's responsibility for the information is less clear because letters of intent are not normally within the scope of the audit of a contractor's financial statements. The auditor may, however, be able to satisfy himself or herself regarding the completeness and reliability of the information on letters of intent. The auditor should consider obtaining a schedule of signed letters of intent, confirming the letters with customers, and reviewing their terms with the contractor's legal counsel.

10.60 As indicated in chapter 6, "Financial Statement Presentation," of this guide, the presentation of backlog information by a contractor is desirable only if a reasonably dependable determination of total revenue and a reasonably dependable estimate of total cost under signed contracts or letters of intent can be made, and the information on signed contracts should be segregated from the information on letters of intent.

Management Representations

10.61 The auditor must obtain written representations from management in accordance with the requirements of AU section 333, *Management Representations* (AICPA, *Professional Standards*). Written representations from management should be obtained for all financial statements and periods covered by the auditor's report.[3] The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of the presentation of the financial statements. Paragraph .06 of AU section 333 lists matters ordinarily included in management's representation letter. Additional representations specific to construction contractors that may be obtained include the following:

- Method of income recognition used
- Provisions for losses on contracts
- Unapproved change orders, claims, and contract postponements or cancellations
- Backlog information if presented in the financial statements
- Contracts completed during the year and in process as of the balance sheet date if presented in the financial statements
- Joint venture participations and other related party transactions

In addition to the foregoing items, the auditor should obtain specific management representations relating to all the types of matters suggested in AU section 333 that are relevant to the engagement.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
>
> When performing an integrated audit, refer to paragraphs 75–77 of Auditing Standard No. 5 for additional required written representations to be obtained from management.

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[3] The written representation should be addressed to the auditor and should be made as of the date of the auditor's report.

Chapter 11

Other Audit Considerations*

11.01 This chapter addresses additional audit considerations that are essential in audits of construction contractors. They include affiliated entities, capitalization and cash flow, types of auditor's reports, and legal and regulatory requirements.

Affiliated Entities

11.02 In the construction industry, contractors frequently participate in joint ventures or have a direct or indirect affiliation with other entities and, as a consequence, are frequently involved in related party transactions as the term *related parties* is defined in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 850, *Related Party Disclosures*. The prevalence of such arrangements in the industry can be attributed to factors such as legal liability, taxation, competition, ownership and operating arrangements, labor and labor union considerations, and regulatory requirements. Auditing and reporting considerations appropriate in the circumstances are discussed in this section.

Participation in Joint Ventures

11.03 The auditor should review a contractor's participations in joint ventures to evaluate whether investments in joint ventures are reported in accordance with the recommendations in chapter 3, "Accounting for and Reporting Investments in Construction Joint Ventures," of this guide. The following are among the factors that may influence the auditor's evaluation:

- The method or methods of reporting joint venture investments
- The nature of capital contributions and the methods of recording capital contributions
- The timeliness of the available financial statements of joint ventures in relation to those of the reporting investor
- The appropriateness of the accounting for joint venture losses that exceed a contractor's loans and investments
- The adequacy of joint venture related disclosures in the contractor's financial statements

11.04 The auditor should review joint venture agreements and document a contractor's participation. Information that the auditor might consider documenting includes the following:

- Capital contributions and funding requirements of the venture participants
- Ownership percentages
- Profit or loss participation ratios
- Duration of the venture

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* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

- Performance requirements of the venture participants
- Financial guarantees or recourse, or both, between the parties

11.05 The audit considerations for a contractor's participation in a partnership (for example, in a real estate tax shelter partnership) are similar to those for participation in corporate joint ventures. They may differ primarily in relation to the contractor's unlimited liability as a general partner for partnership obligations.

11.06 For partnership interests, the auditor might document the following information:

- The extent and nature of fees and other amounts to be paid by the partnership to the contractor and the conditions and events that would require such payments
- The contractor's obligations to the partnership for capital contributions and other funding
- Performance and other requirements of the contractor as a general partner and specified penalties for nonperformance, if any
- Profit participation ratios of the partners and events or conditions that change such ratios
- The duration of the partnership

11.07 The auditor should assess the economic and tax incentives underlying the creation of the partnership, the events requiring capital contribution installments by limited partners, and temporary and permanent financing arrangements and related costs. The auditor should also assess the extent of actual and contingent obligations that arise from the contractor's role as a general partner. To that end, the auditor should review the financial condition of the other general partners and their ability to participate in the funding of required capital contributions, partnership obligations, and partnership losses, if any. The inability of other general partners to provide their share of such funding may require the contractor to recognize additional obligations based on the contractor's legal liability as a general partner for all partnership obligations.

11.08 For any type of venture, the auditor should evaluate the nature of the venture, the scope of its operations, and the extent of involvement of each participant. To further the auditor's understanding, the auditor should obtain financial statements of the venture entity for the period under review. AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*), provides guidance and establishes requirements for audit engagements in which the financial statements of the venture are audited by another independent auditor.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*†
>
> For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*, Auditing

† In August 2010, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). With this release, the PCAOB adopted eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the board's interim auditing standards

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Standards), paragraph .18 states that audit documentation supporting the work performed by other auditors (including auditors associated with other offices of the firm, affiliated firms, or nonaffiliated firms) must be retained by or be accessible to the office (of the principal auditor) issuing the auditor's report. AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), of the PCAOB Auditing Standards states that when the principal auditor decides not to make reference to the audit of the other auditor, in addition to satisfying himself or herself as to the matters described in paragraph .10 of AU section 543, the auditor must obtain, and review and retain, certain audit documentation from the other auditor prior to the report release date.

Also, when performing an integrated audit, refer to paragraphs C8–C11 of appendix C, "Special Reporting Situations," of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

11.09 If the venture's financial statements are unaudited, the principal auditor should perform such procedures as he or she deems necessary in the circumstances to obtain sufficient appropriate audit evidence. For determining what procedures to perform, AU section 332,[1] *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), provides guidance and establishes requirements on auditing investments in debt and equity securities and investments accounted for under FASB ASC 323, *Investments—Equity Method and Joint Ventures*. When such procedures cannot be performed, and the resulting effect is a restriction on the scope of the audit, paragraphs .22–.32 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), provide applicable guidance.

Auditing Affiliated Entities and Related Party Transactions

11.10 An auditor engaged to audit one of a group of affiliated entities that comprises an economic unit may find that an examination of the records of that entity does not satisfy him in regard to such aspects as substance, nature, business purpose, and transfer prices of significant transactions between the parties. AU section 334, *Related Parties* (AICPA, *Professional Standards*), provides guidance and establishes requirements for identifying and reporting on related party transactions. The auditor should be aware of the possible existence of material related party transactions that could affect the financial statements and of common ownership or management control relationships for which FASB ASC 850 requires disclosure even though no transactions exist.

(footnote continued)

and related amendments to PCAOB standards. These standards are effective for audit engagements conducted pursuant to the standards of the PCAOB for fiscal years beginning on or after December 15, 2010. Refer to the preface of this guide for important information about the release and applicability of these standards. Readers can download the entire release, which includes full text of the standards, at http://pcaobus.org/.

[1] For guidance on implementing the requirements of AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), refer to the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

Consolidated or combined financial statements in place of, or supplementary to, the separate financial statements of the entity being audited may sometimes be necessary to present the financial position, results of operations, and cash flows of the entity being audited in accordance with the recommendations in chapter 4, "Financial Reporting by Affiliated Entities," of this guide.

Capitalization and Cash Flow

11.11 Contractors often follow practices that accelerate the cash collections to be generated from a contract. The practices include the use of unbalanced bids and other front-end loading procedures that allocate a relatively larger portion of the total contract price to phases of work likely to be completed in early stages of the contract than to phases likely to be completed later. Also, overestimating the percentage of work completed in computing billings on contracts may have a similar effect on cash collections.

11.12 If a contractor incurs substantial losses on contracts that have been front-end loaded, a cash deficiency toward the end of those contracts may be experienced. The deficiency may prevent the contractor from meeting current obligations, and the contractor may have to front-end load new contracts to generate funds to meet those obligations. The necessity to generate cash may cause the contractor to accept jobs that are only marginally profitable.

11.13 Therefore, the auditor should review uncompleted contracts not only to assess the adequacy of provisions for losses in the current period but also to determine the effect of projected cash receipts and payments on the contractor's cash position and ability to meet current obligations.

Types of Auditor's Reports on Financial Statements

11.14 The auditor's conclusion to issue an unqualified opinion on the financial statements may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards (GAAS). When evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion, AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), provides applicable guidance. Restrictions on the scope of the audit, the inability to obtain sufficient competent audit evidence, or an inadequacy in the accounting records may require the auditor to qualify his or her opinion or to disclaim an opinion as appropriate in the circumstances. The following are examples of situations that may preclude the auditor from issuing a standard report on the financial statements:

- The auditor is unable to evaluate the propriety or collectibility of significant amounts of contract revenue related to claims. Those circumstances may require the auditor to issue a qualified opinion or disclaim an opinion, depending on the particular circumstances.
- A contractor does not maintain detailed cost records by contract, and the auditor is unable to perform extended auditing procedures to obtain sufficient appropriate audit evidence that the data purporting to represent accumulated costs to date are reasonably correct. In this situation, a modified opinion may be appropriate.
- An entity has cash problems because of undercapitalization or because losses have eroded its net worth and threaten its ability to continue to operate as a viable entity. When, in such a situation,

the auditor has evaluated management's plans and concludes that he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should (*a*) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (*b*) include an explanatory paragraph (following the opinion paragraph) in the audit report to reflect his or her conclusion.

Auditor's Communications Related to Internal Control Matters

11.15 Whenever an auditor expresses an opinion (including a disclaimer of opinion) on the financial statements of a nonissuer, AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*), states that the auditor must communicate, in writing, to management and those charged with governance, control deficiencies identified during the audit that are considered significant deficiencies or material weaknesses in the internal control process. The communication required by AU section 325 includes significant deficiencies and material weaknesses identified and communicated to management and those charged with governance in prior audits but not yet remediated. The written communication is best made by the report release date but should be made no later than 60 days following the report release date. Nothing precludes the auditor from communicating to management and those charged with governance other matters that the auditor believes to be of potential benefit to the entity or that the auditor has been requested to communicate, which may include, for example, control deficiencies that are not significant deficiencies or material weaknesses. The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit because of the potential for misinterpretation of the limited degree of assurance provided by such a communication. See paragraphs .07–.10 of chapter 9 for additional guidance auditor communication.

Legal and Regulatory Considerations

State Statutes Affecting Construction Contractors

11.16 The auditor should be aware of the existence in some states of *lien* laws. Those laws vary from state to state but generally provide that funds received or receivable by a contractor constitute trust funds that may only be used to pay specified contract-related costs. The auditor should review with the contractor and the contractor's counsel the applicable statute in each state in which the contractor operates to evaluate whether amounts that constitute trust funds under those statutes have been properly applied. Other state statutes may also have audit or disclosure requirements. The auditor should consider such statutes in the performance of an audit and in the evaluation of the adequacy of financial statement disclosures.

11.17 AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*),[2] states that the auditor should be aware of the possibility that illegal

[2] In November 2004, the AICPA's Professional Issues Task Force (PITF) issued Practice Alert 2004-1, *Illegal Acts* (AICPA, *Technical Practice Aids*, PA sec. 16,270), to provide auditors of

(continued)

acts may have occurred. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred. An audit made in accordance with GAAS provides no assurance that illegal acts will be detected or that any contingent liabilities will be disclosed. However, when the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit.

Governmental Prequalification Reporting

11.18 Contractors are often required to file reports with agencies of the federal, state, or county governments in order to qualify for bidding on or performing work for such agencies. The report format required by the regulatory agencies may include preprinted auditors' reports, which differ from reports issued in conformity with GAAS or the standards of the PCAOB. In these circumstances, paragraphs .32–.33 of AU section 623, *Special Reports* (AICPA, *Professional Standards*), provide applicable guidance. A suggested form of auditor's report that could be substituted for the preprinted report in the regulatory filing form follows.

Independent Auditor's Report

We have audited the accompanying statement of assets, liabilities, and surplus of XYZ Company as of December 31, 20XX, and the related statements of income and changes in surplus for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[3] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's*

(footnote continued)

nonissuers and their firms with guidance regarding the extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted auditing standards. The alert provides guidance regarding the auditor's responsibility for detecting illegal acts that have a direct or indirect effect on the financial statements; audit procedures in the absence of specific information indicating the existence of possible illegal acts; what should be done if you discover possible illegal acts; disclosure of illegal acts to third parties; and reporting considerations and documentation. The PITF encourages practitioners and AICPA member firms to incorporate the guidance contained in the alert as soon as practicable. The alert is currently available on the AICPA's website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/PracticeAlerts/pa_2004_1.pdf.

[3] For audits conducted in accordance with PCAOB standards, Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence, "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." Please refer to footnote 1 in appendix E for more information.

internal control over financial reporting. Accordingly, we express no such opinion.][4] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying financial statements were prepared for the purpose of state construction prequalification filings on the basis of accounting practices prescribed by the state in which filed as described in Note X and are not intended to be a presentation in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and surplus of XYZ Company as of [at] December 31, 20XX, and its income and changes in surplus for the year then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of [*the specified parties*] and is not intended to be and should not be used by anyone other than these specified parties.

* * *

Note X. It is the policy of the Company to prepare financial statements intended solely for a state authority on the basis prescribed by that state authority. This report has been prepared for [*name of state authority*] on the basis prescribed by them. This basis differs from accounting principles generally accepted in the United States of America in the following respects:

1. A statement of cash flows is not included.
2. ____________________________
3. ____________________________
4. ____________________________

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[4] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing, and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Chapter 12

Consideration of Fraud in a Financial Statement*

12.01 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 (AICPA, *Professional Standards*) establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, as stated in AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*).

> *Considerations for Audits Performed in Accordance With PCAOB Standards*†
>
> When performing an integrated audit, refer to paragraphs 14–15 of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), regarding fraud considerations, in addition to the fraud considerations set forth in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).[1]

12.02 Two types of misstatements that are relevant to the auditor's consideration of fraud in a financial statement audit are misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Additionally, three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure,* which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud

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* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

† In August 2010, the Public Company Accounting Oversight Board (PCAOB) issued Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). With this release, the PCAOB adopted eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the board's interim auditing standards and related amendments to PCAOB standards. These standards are effective for audit engagements conducted pursuant to the standards of the PCAOB for fiscal years beginning on or after December 15, 2010. Refer to the preface of this guide for important information about the release and applicability of these standards. Readers can download the entire release, which includes full text of the standards, at http://pcaobus.org/.

[1] In January 2007, the PCAOB issued Release No. 2007-001, *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases). The report does not change or propose to change any existing standard, nor is the report meant to provide a new interpretation of any aspect of existing standards. The board has, however, identified certain observations, made in the course of board inspections, that are sufficiently important or arise with sufficient frequency to warrant discussion in a public report, both for the purpose of generally focusing auditors on being diligent about these matters and for the purpose of providing information that audit committees may find useful in working with auditors. Readers can download the report at http://pcaobus.org/Inspections/Documents/2007_01-22_Release_2007-001.pdf.

to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

12.03 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud[2]

12.04 Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of paragraphs .14–.18 of AU section 316 (AICPA, *Professional Standards*). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (*a*) create incentives or pressures for management and others to commit fraud, (*b*) provide the opportunity for fraud to be perpetrated, and (*c*) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit.

12.05 Although there certainly are a number of large national and international construction contractors, some of which are public entities, the vast majority of contractors are privately owned businesses. The latter group within the construction industry tends to be dominated by a large number of family-owned contractors whose operations are conducted through various forms of organizations including corporations, partnerships, and limited liability entities. Those organizations, in turn, enter into joint ventures of all forms. It is common for construction contractors to own or control more than one operating entity. The term *double-breasting* refers to simultaneous operation of both a union contractor and a nonunion contractor. This is done to enable bidding on jobs regardless of the contract-mandated labor requirements.

12.06 In certain regions of the country, especially those that are highly unionized, the construction industry has historically experienced corruption. Despite the absence of any existing evidence of corruption, and regardless

[2] The brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session required under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), to discuss the potential of the risks of material misstatement.

of any past experience with the industry, the entity, or management, the discussion among the auditing team should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit.

12.07 Although every commercial transaction may be subject to the risk of fraud, the construction industry has been especially affected by frauds resulting from, among other factors

- dependence on consultants or government officials, or both, for obtaining regulatory approvals.
- noncompliance with labor laws and collective bargaining agreements.
- high-dollar value of many of the contracts.
- requirements to accept lowest bidders.
- dependence on consultants, including development managers, architects, and engineers for good-faith exercise of discretion.

12.08 Certain aspects of the construction industry can create a higher risk of the presence of fraud occurring at a construction entity. These items are discussed in the following list:

- *Incentives and Pressures*
  - The percentage of completion method requires that loss contacts be accrued. A strong incentive exists for contractors to avoid such recognition by charging costs on jobs that are likely to result in losses to more profitable jobs to prevent the loss accrual or the contractor may allocate additional costs to a job that is already showing a loss, while underallocating costs to profitable jobs in order to make those jobs reflect more profits.
  - Bonding generally is a requirement to bid on most large and nearly all government contracts. Bonding companies go through a working capital type calculation to determine *bonding capacity*. That calculation assigns differing weights by category of assets and generally excludes prepaid amounts, amounts due from related parties, and provides credit for only half of the inventory. Knowing the formula behind the calculation provides the contractor an incentive to mask amounts due from related parties and allocate inventory and prepaid amounts to current job costs, thus reclassifying those costs on the balance sheet by either increasing underbillings or decreasing overbillings (and, as a further consequence of the abuse, accelerating revenue recognition on the jobs to which they are charged).
  - Profit fade (the reduction of the estimated gross profit over the life of a contract) is recognized as evidence of a contractor's inability to effectively estimate or manage a job, or both. In order to prevent profit fade from appearing

on an older job, contractors may attempt to inappropriately charge costs on those older jobs to newer ones.

— Very few bidders on a job and very high gross profit margins on jobs both may be signs that the bidding process is influenced by corruption.

— Depending on the nature of the employee-employer relationship and the construction contract, some employees may feel little loyalty to the projects they work on and have no inclination to complete work on time. Line employees may steal materials or intentionally create time and cost overruns to extend their own employment. As material and labor costs soar during the construction phase, support personnel in accounting or purchasing departments may concoct inventory or accounts payable schemes to defraud their employers or customers.

— Pressure to meet covenants required by financial institutions for lines of credit or borrowings.

— Incentives due to management or employee, or both, bonus arrangements, based on job profitability.

- *Opportunities*

— Completed jobs often have unused materials left over. A scheme used by some contractors is to commingle those materials with recently purchased ones. In the year-end physical inventory, those with no cost are not identified as such, and the "recycled" inventory is repriced at historical cost along with the other items counted. And the book to physical inventory adjustment masks the reintroduction of the "recycled" materials into inventory.

— Most job costs are for materials and labor, which are costs that are not always project-specific. It is not unheard of for a contractor to charge personal costs to a job. Vehicle costs are not uncommon for construction contracts, and the cost of personal vehicles leased for family members do not stand out as unusual job costs. It is not unheard of for contractors to have built personal residences for themselves, family members, government and union officials and to charge those costs to a job or to a series of jobs. Similarly, "favors" in the form of repaving driveways, excavating a lot, or building a stonewall are some of the inappropriate items that sometimes may be charged to contracts.

— Significant equipment purchases are charged directly to contract job costs. Some contractors may inappropriately charge to a job the entire cost of capitalizable construction equipment all at once instead of capitalizing this equipment, depreciating it over its useful life, and allocating to the job only an applicable portion of depreciation

expense. When a contractor uses the percentage of completion method, this will accelerate the revenue recognition process by increasing costs incurred to date. In an effort to further improve its profitability, the construction contractor may also attempt to charge its client for equipment that may be used on several jobs by either submitting change orders for fixed-price contracts or by simply including this equipment among costs for time-and-materials contracts.

— Because the percentage of completion method of accounting for long-term construction-type contracts is required whenever contractors have the ability to make reasonably dependable estimates, the estimate of total contract costs (incurred and to be incurred) is uniquely critical to the revenue recognition process in this industry. Underestimation of total contract cost would present the contract as more complete than it is and, as a consequence, would result in excess gross profit on the job and overstated operating results for the entity. Because of the subjective nature inherent in estimating total costs and costs to complete, the contractor is in a unique position to influence those estimates and, as a direct consequence, the operating results for the period.

- *Attitudes and Rationalizations*

— Many construction contractors will do whatever it takes to get the job. Financial reporting is considered merely a requirement to get the necessary loans and bonding to be able to effectively participate in the industry. The industry is a tough one in which to participate, and those who have been successful have had to apply good business judgment to overcome the constant challenges to their integrity.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

12.09 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), establishes requirements and provides guidance about how the auditor obtains an understanding of the entity and its environment, including its internal control for the purpose of assessing the risks of material misstatement. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in paragraphs .35–.42 of AU section 316 [AICPA, *Professional Standards*]) to identify the risks of material misstatement due to fraud:

a. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are

addressed. (See paragraphs .20–.27 of AU section 316 [AICPA, *Professional Standards*].)

b. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See paragraphs .28–.30 of AU section 316 [AICPA, *Professional Standards*].)

c. Consider whether one or more fraud risk factors exist. (See paragraphs .31–.33 of AU section 316 [AICPA, *Professional Standards*] and paragraphs 12.11–.12.)

d. Consider other information that may be helpful in the identification of risks of material misstatement due to fraud. (See paragraph .34 of AU section 316 [AICPA, *Professional Standards*].)

12.10 In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting. For example, in the construction industry, the following unusual or unexpected relationships may indicate a material misstatement due to fraud:

- Underbillings on uncompleted contracts that exceed 20 percent of equity or 25 percent of working capital, the explanation for which may include the masking losses or costs unrelated to a job being charged to that job
- Continually increasing underbillings, which may indicate that potential losses are being capitalized
- Overbillings that are not represented by cash, the explanation for which may include the use of excess cash collections to finance other possible loss contracts
- A higher gross profit on uncompleted contracts than on closed jobs, which may indicate an overly optimistic estimate of profitability on open jobs
- Inability to reconcile total costs incurred on open jobs and closed jobs to the total costs presented on the statement of operations, which may suggest that closed jobs may have been charged for current costs

Considering Fraud Risk Factors

12.11 As indicated in paragraph 12.09(c), the auditor may identify events or conditions that indicate incentives or pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes and rationalizations to justify a fraudulent action. Such events or conditions are referred to as *fraud risk factors*. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

12.12 AU section 316 (AICPA, *Professional Standards*) provides fraud risk factor examples that have been written to apply to most enterprises. Paragraph 12.08 provides a list of fraud risk factors specific to the construction industry. Remember that fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

Identifying Risks That May Result in a Material Misstatement Due to Fraud[3]

12.13 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of paragraphs .19–.34 of AU section 316 (AICPA, *Professional Standards*). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

12.14 As discussed, due to the nature of the construction industry, a number of accounts can be subject to fraudulent activities including underbillings and overbillings, inventory, prepaid expenses, and fixed assets. In addition, from a standpoint of potential manipulation of financial results, a few of the areas that involve the most judgment and, therefore, present the greatest risk of manipulation are described as follows:

- *Penalty clauses.* Municipal contracts, especially school contracts, very often contain penalty clauses for late completion of jobs. Those penalties are usually assessed on a daily basis, and they can become substantial. Often, contractors neglect to charge such costs to jobs as they are incurred in the hope that somehow those penalty amounts will be waived. Because they are contract costs, penalties should be accrued and charged to job costs as incurred. These penalty clauses may come in the form of liquidated damages (per the terms of the contract), actual damages assessed by the owner, or back charges.
- *Davis-Bacon Act consideration.* Contracts entered into by nonunion contractors covered by the Davis-Bacon Act require that contractors pay for nonunion labor at the prevailing wage of union workers. The differential between the prevailing union wage and the actual wage often is not paid directly to the worker but to a supplemental benefit plan that benefits the worker. Such payments are made less often than payroll payments. It is not uncommon to discover that such unpaid costs have not been accrued and charged to the job on a contemporaneous basis.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

12.15 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of

[3] Paragraph .102 of AU section 314 states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See paragraph .41 of AU section 316 [AICPA, *Professional Standards*].)

12.16 As discussed previously, revenue recognition process for construction contractors using the percentage of completion method is often based on an estimate of total cost. Underestimation of total contract cost would present the contract as more complete than it really is and, as a consequence, would result in excess gross profit on the job and acceleration of the revenue recognition process. Preparation of accurate work in process schedules is essential for proper revenue recognition. Care needs to be exercised to ensure that the costs incurred to date schedule includes all costs that actually have been incurred through the period-end and that no significant unrecorded liabilities exist. Then, the actual costs and the estimate of costs to be incurred are a meaningful estimate of total costs to use in estimating revenue. If the costs incurred to date schedule is incomplete, then total costs will most likely be understated, which will result in inaccurate revenue recognition, regardless of the revenue recognition method used by the contractor.

12.17 A popular misconception is that unrecorded liabilities only increase revenue in percentage of completion accounting. That would be so only if unrecorded liabilities excluded from the costs incurred to date were picked up in the estimate of costs to complete. However, this will not be the case if a contractor relies on an engineering assessment instead of the accounting system to estimate costs to complete by observing what has been done and what remains to be done. Auditors should select certain job sites for observation and discussion of stage of completion with engineering personnel. Contracts under 10 percent complete and over 90 percent complete generally present less risk to the auditor. This is simply because those under 10 percent complete have relatively little revenue recognized based on the estimates. Those over 90 percent complete are at a stage at which most of the costs have been incurred; therefore, the risk of revenue manipulation is minimized at this point.

12.18 Revenue recognition may be accelerated if a contractor reclassifies inventory and prepaid amounts to current job costs to satisfy working capital requirements of bonding companies.

12.19 Contractors also may accelerate revenue recognition by inappropriately charging to a job the entire cost of capitalizable construction equipment all at once instead of capitalizing this equipment, depreciating it over its useful life, and allocating to the job only an applicable portion of depreciation expense. When a contractor uses the percentage of completion method, this will accelerate the revenue recognition process by increasing costs incurred to date. In an effort to further increase its revenues, the construction contractor may also attempt to charge its client for equipment that may be used on several jobs by either submitting change orders for fixed-price contracts or by simply including this equipment among costs for time-and-materials contracts.

12.20 If the contractor has adopted the accounting policy that allows for total costs recognition on claims receivable, then the amount to be recognized should be limited to the actual costs incurred deemed to be realizable. Often, claims information is based on estimates prepared by outside consultants who are preparing for litigation. Those estimates generally include costs that are not recognizable under Financial Accounting Standards Board (FASB) *Accounting*

Standards Codification (ASC) 605-35, and care needs to be exercised to ensure that amounts recognized are limited to the actual costs incurred.

12.21 Some construction contractors may assert the inability to estimate costs in an attempt to justify continued use of the completed contract method allowed in FASB ASC 605-35 under such circumstances. Such claims may have had some validity decades ago when estimates were done by hand; however, the abundance of off-the-shelf software that assists in making estimates and tracking costs on contracts renders most of such claims invalid.

A Consideration of the Risk of Management Override of Controls

12.22 Even if specific risks of material misstatement due to fraud are not identified by the auditor, a possibility exists that management override of controls could occur, and accordingly, the auditor should address that risk (see paragraph .57 of AU section 316 [AICPA, *Professional Standards*]) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in paragraphs .58–.67 of AU section 316 (AICPA, *Professional Standards*) should be performed to further address the risk of management override of controls. These procedures include (*a*) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (*b*) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (*c*) evaluating the business rationale for significant unusual transactions.

Key Estimates

12.23 Key estimates in the construction industry involve the following items:

- Cost to complete
- Contract penalties and incentives
- Profit from change orders
- Revenue from claims
- Allocation of equipment costs
- Stage of completion
- Accounts receivable allowance
- Assumptions regarding impairments of long-lived assets
- Assumptions regarding deferred tax valuation allowances and effective tax rates

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

12.24 Paragraphs .43–.45 of AU section 316 (AICPA, *Professional Standards*) provide guidance and set forth requirements concerning an entity's programs and controls that address identified risks of material misstatement due to fraud. Although the majority of construction contractors are privately owned businesses, there certainly are a number of large national and international contractors that have a strong system of internal controls. The following are examples of programs and controls that can be found in larger construction entities:

- Contractors have extensive systems for the identification and recognition of costs by job.
- Contractors have sophisticated systems to assist engineering personnel in making cost to complete estimates.
- Construction contractors generally are hands-on managers with intimate knowledge of the jobs, the progress on the job, and the expected completion of the job.
- Many privately owned construction entities are owned and managed by someone who has participated in the trades at many levels and therefore has intimate knowledge of the complexities of the trade and what can go wrong.
- Contractors have corporate policies, particularly in the areas of employee relations and enforcement, to establish an environment that minimizes the risk of fraud. Both management and lower level employees are less likely to engage in fraud, commercial crime, or destructive acts if they believe they have a stake in the entity and
    - — they are being fairly treated, for example, with respect to compensation.
    - — any employee will be severely dealt with for any breach of the law or the entity's policies.
- Construction contractors have physical access restrictions, for example, with respect to construction materials and supplies at the entity's premises and at work sites, will deter theft or sabotage.
- Contractors have supervisory performance and independence checks to ensure that the entity's work is up to contract standards and minimize the potential for materials substitution or other quality problems.
- Contractors carry adequate insurance (for example, fidelity, liability, and theft).

12.25 The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud or whether specific control deficiencies exacerbate the risks. After the auditor has evaluated whether the entity's programs and controls have been suitably designed and placed in operation, the auditor should assess these risks, taking into account that evaluation. This assessment should be considered when developing the auditor's response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment[4]

12.26 Paragraphs .46–.67 of AU section 316 (AICPA, *Professional Standards*) provide requirements and guidance about an auditor's response to the

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[4] Paragraphs .03–.07 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), state that the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures to respond to the assessed risks of material misstatement at the relevant assertion level in a financial statement audit. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

- A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned. (See paragraph .50 of AU section 316 [AICPA, *Professional Standards*].)
- A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed. (See paragraphs .51–.56 of AU section 316 [AICPA, *Professional Standards*].) Construction audit procedures may include the following:
  - — Holding regular meetings with owners and project managers.
  - — Reviewing monthly internal financial reports with appropriate contractor personnel to include detailed review of work in process job schedule.
  - — Performing testing of the contractor's internal controls over job costing and contracts receivable.
  - — Reviewing analytical review procedures used by the contractor to identify fraudulent actions and understand the results of these analyses. Depending on the results, additional procedures may be necessary.
  - — Scheduling job site visits at or near year end and discuss progress on job to date with on-site personnel, especially those not directly involved in the preparation of the estimate of costs to complete.
  - — Inquiring with employees of various levels regarding their understanding of fraud risk factors, controls in place, and any known illegal acts or fraud.
- A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur. (See paragraphs .57–.67 of AU section 316 [AICPA, *Professional Standards*].)

Evaluating Audit Evidence

12.27 Paragraphs .68–.78 of AU section 316 (AICPA, *Professional Standards*) provide requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures[5] that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about

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[5] Refer to the AICPA Audit Guide *Analytical Procedures* for guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This includes a discussion of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), and the underlying concepts and definitions, a series of questions and answers, an illustrative case study, and an appendix that includes useful financial ratios.

analytical relationships have been vague or implausible or have produced evidence that is inconsistent with other audit evidence accumulated during the audit.

12.28 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

12.29 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See paragraphs .75–.78 of AU section 316 (AICPA, *Professional Standards*) for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the financial statements, the auditor, nevertheless, should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

12.30 If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

a. attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon.[6]

b. consider the implications for other aspects of the audit. (See paragraph .76 of AU section 316 [AICPA, *Professional Standards*].)

c. discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved and with senior management and those charged with governance.[7]

d. if appropriate, suggest that the client consult with legal counsel.

12.31 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

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[6] See AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), for guidance related to auditors' reports issued in connection with audits of financial statements.

[7] If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

12.32 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See paragraphs .79–.82 of AU section 316 (AICPA, *Professional Standards*) for further requirements and guidance about communications with management, those charged with governance, and others.

> *Considerations for Audits Performed in Accordance With PCAOB Standards*
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> Paragraph .80 of AU section 316 (AICPA, *PCAOB Standards and Related Rules*, Interim Standards) states that if the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected), the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee.

Documenting the Auditor's Consideration of Fraud

12.33 Paragraph .83 of AU section 316 (AICPA, *Professional Standards*) lists certain items and events that the auditor should document.

Appendix A

Illustrations of Segmenting Criteria

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35 provides revenue recognition guidance for contractors. Information relating to the segmenting of contracts for revenue recognition purposes and the criteria for segmenting are discussed in paragraphs 10–13 of FASB ASC 605-35-25. The following examples illustrate the application of those criteria in specific circumstances:

1. A design or build contractor, or both, negotiates a contract that provides for design engineering, procurement, and construction of a nuclear power plant. The contract specifies the separate phases of the work, and, for this type of project, the phases are frequently contracted separately. Moreover, the contractor has a significant history of providing similar services to other customers contracting for the phases separately. Such a history shows a relatively stable pricing policy. The contractor's normal fee on design engineering is 15 percent; on procurement, 2 percent; and on construction, 5 percent. These rates are commensurate with the different levels of risk attributable to the separate phases, and the aggregate of the values of the separate phases produced from such a fee structure is approximately equal to the overall contract price. The similarity of services and prices in the contract segments to services and the prices of such services to other customers contracted separately is documented and verifiable. The contract does not meet the first set of criteria in FASB ASC 605-35-25-12 but does meet the second set of criteria in FASB ASC 605-35-25-13 and, therefore, qualifies for segmenting. However, if any one of the required conditions in FASB ASC 605-35-25-13 is not met, segmenting would not be appropriate. For example, the contractor's significant history might have been with fossil fueled instead of nuclear powered generating plants. Or the different gross profit rates, even though supported by the contractor's history, might not be justified by different levels of risk or by disparities in the relationship of supply and demand for the segment services. Such circumstances could arise from an erratic or unusual labor market for a particular project.

2. A contract provides for construction of an apartment building, swimming pool, and other amenities. The contractor has a significant history of providing similar services to other customers who have contracted for such services separately. His or her significant history is one of a relatively stable pricing policy. He or she wishes to assign values to the segments on the basis of his or her normal historical prices and terms to such customers. On that basis, the aggregate of the segment values will approximate the total contract price. However, although this contractor performs the phases separately, the practice is unusual and is not done by other contractors in the industry. Also, the different gross profit rates that the contractor would ascribe to the segments based on his or her history cannot practicably be related to economic risk or supply and demand disparities. Because the facts do not meet the criteria in

paragraphs 12–13 of FASB ASC 605-35-25, the contract should not be segmented.

3. A contractor is a road builder, performing alternately under contracts in which much of the work is subcontracted and under contracts in which he or she performs all the work himself or herself. Under contracts involving subcontractors, the contractor generally realizes a lower profit margin due to the spread of risk to subcontractors. He or she, therefore, wishes to segment his or her contract revenues between the subcontracted portions of the work and the portions that he or she performs himself or herself, assigning a greater amount of revenue to the latter and a lesser amount to the former. His or her history with both types of work is significant and is supported by a relatively stable pricing policy. However, it is not customary for the portions of the work to which the greater amounts of revenue are to be ascribed to be contracted separately from the other portions. The contract should not be segmented because the criteria in neither FASB ASC 605-35-25-12 nor FASB ASC 605-35-25-13 are met.
4. An electrical and mechanical subcontractor is awarded both the electrical and mechanical work based on separate, independent bids. Separate subcontracts are signed and become the profit centers for profit recognition purposes. Had the work been negotiated as a package, the contract might have been segmented only if the criteria in either FASB ASC 605-35-25-12 or FASB ASC 605-35-25-13 had been met.
5. A contractor is awarded a contract to construct three virtually identical generating power plants in different locations. His or her costs will vary because of differences in site work, transportation, labor conditions, and other factors at the three locations. He or she wishes to segment contract revenues in response to cost differences. He or she has a significant history of constructing generating plants under separate contracts under a relatively stable pricing policy. However, segmenting contract revenues on this basis would not be commensurate with the different levels of risk or the supply or demand disparities of the three projects. The contract should not be segmented in these circumstances.

Appendix B

Computing Income Earned Under the Percentage-of-Completion Method

Illustration of the Alternative A Procedure

The following hypothetical data are used to illustrate the computation of income earned under the alternative A procedure described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35-25-83. A contracting company has a lump-sum contract for $9 million to build a bridge at a total estimated cost of $8 million. The construction period covers 3 years. Financial data during the construction period are as follows.

	Year 1	*Year 2*	*Year 3*
	(in thousands of dollars)		
Total estimated revenue	$9,000	$9,100	$9,200
Cost incurred to date	$2,050	$6,100	$8,200
Estimated cost to complete	6,000	2,000	—
Total estimated cost	$8,050	$8,100	$8,200
Estimated gross profit	$950	$1,000	$1,000
Billings to date	$1,800	$5,500	$9,200
Collections to date	$1,500	$5,000	$9,200
Measure of progress	25%	75%	100%

The amount of revenue, costs, and income recognized in the three periods would be as follows.

	To Date	*Recognized Prior Year(s)*	*Current Year*
Year 1			
Earned revenue			
($9,000,000 x .25)	$2,250.0		$2,250.0
Cost of earned revenue	2,050.0		2,050.0
Gross profit	$200.0		$200.0
Gross profit rate	8.8%		8.8%
Year 2			
Earned revenue			
($9,100,000 x .75)	$6,825.0	$2,250.0	$4,575.0
Cost of earned revenue	6,100.0	2,050.0	4,050.0
Gross profit	$725.0	$200.0	$525.0
Gross profit rate	10.6%	8.8%	11.5%
Year 3			
Earned revenue	$9,200.0	$6,825.0	$2,375.0
Cost of earned revenue	8,200.0	6,100.0	2,100.0
Gross profit	$1,000.0	$725.0	$275.0
Gross profit rate	10.9%	10.6%	11.6%

Comparison of Alternative A and Alternative B

The following hypothetical data are used to compare the income statement and balance sheet effects of alternative A described in FASB ASC 605-35-25-83 and alternative B described in FASB ASC 605-35-25-84.

Estimated Contract		
Revenues		$1,000,000
Cost		900,000
Gross profit		$100,000
% of gross profit		10%
Annual Information	*To Date*	*Current*
Year 1		
Billings	$200,000	$200,000
Cost incurred	300,000	300,000
% complete	25%	
Year 2		
Billings	$750,000	$550,000
Cost incurred	650,000	350,000
% complete	75%	
Year 3		
Billings	$1,000,000	$250,000
Cost incurred	900,000	250,000
% complete	100%	

The results of measuring earned revenues, cost of earned revenues, and gross profit by alternative A and alternative B would be as follows.

	Alternative A	*Alternative B*
Income Statement		
Year 1		
Earned revenue	$250,000	$325,000
Cost of earned revenue	225,000	300,000
Gross profit	$25,000	$25,000
% of gross profit	10%	7.7%
Year 2		
Earned revenue	$500,000	$400,000
Cost of earned revenue	450,000	350,000
Gross profit	$50,000	$50,000
% of gross profit	10%	12.5%
Year 3		
Earned revenue	$250,000	$275,000
Cost of earned revenue	225,000	250,000
Gross profit	$25,000	$25,000
% of gross profit	10%	9.1%
Balance Sheet Debit (Credit)		
Alternative A		
Year 1		
Cost of uncompleted contracts and estimated profit in excess of billings	$50,000	
Unbilled revenues		$50,000
Alternative B		
Year 1		
Cost of uncompleted contracts and estimated profit in excess of billings	$125,000	
Unbilled revenues		$125,000
Year 2		
Excess of billings over costs incurred and estimated earnings on uncompleted contracts	$(25,000)	
Excess billings		$(25,000)

Discussion of the Results Under the Two Methods

Under alternative A, earned revenue, cost of earned revenue, and gross profit are measured by the extent of progress toward completion. Under alternative

B, only the amount of gross profit is measured by the extent of progress toward completion. Therefore, the same amount of gross profit is reported under either method. However, under alternative B, earned revenue is the amount of costs incurred during the period plus the amount of gross profit recognized based on the extent of progress toward completion, and the cost of earned revenue is the amount of costs incurred during the period. For that reason, earned revenue and cost of earned revenue under alternative B are not comparable to the measurement of extent of progress toward completion unless the extent of progress is measured by the cost-to-cost method.

Appendix C

Examples of Computation of Income Earned

Exhibit Description	*Exhibit Number*
Cost-to-Cost Method	1
Labor-Hours Method	2
Construction Management	3
Unit Price	4
Zero Profit	5
Loss Contract	6
Combining	7
Segmenting	8

For convenience and consistency, all computations are based on the alternative A procedure described in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 605-35-25-83.

Exhibit C-1—Cost-to-Cost Method

A general contractor specializes in the construction of commercial and industrial buildings. The contractor is experienced in bidding long-term construction projects of this type, with the typical project lasting 15–24 months. The contractor uses the percentage-of-completion method of revenue recognition because, given the characteristics of the contractor's business and contracts, it is the most appropriate method. That is, the contracts entered into by the contractor normally specify clearly the rights of the parties regarding services to be provided and consideration, and the contractor has demonstrated the ability to provide dependable estimates of contract revenue, contract costs, and gross profit. Progress toward completion is measured on the basis of incurred costs to estimated total costs because, in the opinion of management, this basis of measurement is most appropriate in the circumstances.

The entity began work on a lump-sum contract at the beginning of year 1. As bid, the statistics were as follows:

Lump-sum price		$1,500,000
Estimated costs		
Labor	$300,000	
Materials and subcontractors	800,000	
Indirect costs	100,000	1,200,000
Estimated gross profit		$300,000

After construction began, a change order was negotiated, increasing the lump-sum price by $150,000 at an estimated additional contract cost of $120,000 (labor: $10,000, materials: $110,000).

At the end of the first year, the following was the status of the contract:

Billings to date		$800,000
Costs incurred to date		
Labor	$120,000	
Materials and subcontractors	478,000	
Indirect costs	50,000	648,000
Latest forecast total cost		1,320,000

Costs incurred to date include $40,000 for standard electrical and mechanical materials stored on the job site and $80,000 for steel in the fabricator's plant (including steel cost of $60,000 and labor cost of $20,000 based on 1,000 hours at $20 per hour). The steel is 100 percent complete and has been fabricated specifically to meet the unique requirements of this job.

Computations for the percentage-of-completion method follow:

$$\text{Measure of progress} = \frac{\text{Costs incurred to date}}{\text{Estimated total cost}}$$

$$= \frac{\$648{,}000 - \$40{,}000}{\$1{,}320{,}0000}$$

$$= 46\%\ \text{complete}$$

$$\text{Earned revenue} = 46\%\ \text{x}\ (\$1{,}500{,}000 + \$150{,}000)$$

$$= \$759{,}000$$

$$\text{Cost of earned revenue} = 46\%\ \text{x}\ (\$1{,}200{,}000 + \$120{,}000)^{1}$$

$$= \$608{,}000$$

The costs of the electrical and mechanical materials at the job site are excluded from "costs incurred to date" because the materials consist of stock items and have not yet become an integral part of the project; on the other hand, the $80,000 of steel is included in "costs incurred to date" because the steel is now specifically fabricated to meet the specifications of this project and, therefore, may be considered a part of the project at this point.

Therefore, an entry is required to reclassify the $40,000 cost of materials not installed from accumulated cost of contracts in progress to materials inventory. Also, an entry must be made to reflect earned revenue and related costs in the income and expense accounts. On the assumption that all costs related to the contract have been charged to the balance sheet account (the costs of contracts in progress), and all billings have been credited to the balance sheet account (progress billings), the following entry would be made:

Balance Sheet	*DR*	*CR*
Progress billings	$800,000	
Costs of contracts in progress		$608,000
Billings in excess of costs and estimated earnings on uncompleted contracts		$41,000

[1] This may also be calculated as the indirect costs of $648,000 minus the stored standard electrical and mechanical materials stored on the job of $40,000.

Income Statement	DR	CR
Earned contract revenue		$759,000
Costs of earned contract revenue	$608,000	

Assuming the contract is completed in the next year with no change in price or cost, the results would appear in the income statement as follows:

	Year		
	1	*2*	*Total*
Progress measurement at end of year	46%	100%	
Contract operations			
Earned revenue	$759,000	$891,000	$1,650,000
Costs			
Labor	$120,000	$190,000	$310,000
Materials and subcontractors	438,000	472,000	910,000
Indirect costs	50,000	50,000	100,000
	$608,000	$712,000	$1,320,000
Gross profit	$151,000	$179,000	$330,000
Gross profit rate	20%	20%	20%

Exhibit C-2—Labor-Hours Method

A general contractor specializes in the construction of industrial plants for manufacturing businesses. The construction period of the typical manufacturing facility ranges from 13 to 24 months. Because of the nature of the construction contracts and the practices followed by the contractor, the contractor has determined that the percentage-of-completion method of revenue recognition is appropriate and that the labor-hours method is the best measure of progress toward completion.

Estimated labor hours must include the labor hours of the entity as well as the labor hours of its subcontractors that produce goods specifically for the project. For example, labor hours incurred by a steel entity in the production of standard items for the project are not included in total labor hours; however, labor hours incurred by a steel entity in fabricating standard items specifically for the project are included in total hours. If management is unable to obtain accurate estimates of its own or all appropriate subcontractors' labor hours at the beginning of the project and as work progresses, the labor-hours method would not be appropriate.

The assumptions and data used in this illustration are identical to those used in exhibit C-1 except that the contractor uses the labor-hours method instead of the cost-to-cost method.

At the end of the first year, the entity had incurred 6,000 labor hours, the steel fabricator 1,000 labor hours, and all other subcontractors 3,080 labor hours. Estimated total labor hours for the project are 21,000.

Computations under the percentage-of-completion method follow:

Measure of progress	=	Labor hours to date (10,080) / Estimated total labor hours (21,000)
Percentage complete	=	48%
Earned revenue	=	48% x ($1,500,000 + $150,000)
	=	$792,000
Cost of earned revenue	=	48% x ($1,200,000 + $120,000)
	=	$633,600

An entry is required to transfer the $40,000 cost of materials that have not entered into the revenue recognition process from accumulated cost of contracts in progress to materials inventory.

Materials inventory	$40,000	
Cost of contracts in progress		$40,000

After the adjustment, the balance in the cost-of-contracts-in-progress account is $608,000 ($648,000 – $40,000); however, because the cost of earned revenue is $633,600, an additional adjustment of $25,600 ($633,600 – $608,000 = $25,600) is required to properly state the cost associated with the revenue earned for the period.

Cost of contract in progress	$25,600	
Liability for contract work to be performed		$25,600

Assuming that the contract is completed in the next fiscal year with no change in price or cost, the results would appear in the income statement.

	Year		
	1	*2*	*Total*
Contract operations			
Earned revenue	$792,000	$858,000	$1,650,000
Cost of revenue earned	633,600	686,400	1,320,000
Gross profit	$158,400	$171,600	$330,000

Exhibit C-3—Construction Management

A construction entity enters into a construction management contract for the construction of a paper mill. The contract is a cost-plus contract in which the contractor acts solely in the capacity of an agent and has no risks associated with the costs managed. That is, the contractor is not responsible for the nature, type, characteristics, or specifications of materials or for the ultimate acceptance of the project; moreover, the contractor's fee was based on the lack of risk inherent in the negotiated contract.

Consistent with the "risk-free" nature of the management contract, the entity measures job progress based on the labor hours for which it has direct control. That is, only those labor hours incurred as a result of the actual management

effort should be used to measure job progress. Thus, the hours incurred by the various contractors and subcontractors on the project do not enter into the measure of job progress from the construction manager's standpoint.

The contractor may accrue his or her fees as they become billable, assuming they are at a constant percentage of costs incurred. The following example, which assumes that the contractor employs the labor-hours method, gives the same results, because labor hours are the basis for fee reimbursement. Because he or she has no risks associated with subcontractors' work, their labor hours are excluded from the computation.

Assume the following:

Total estimated construction management hours	10,000	
Cost per hour (includes indirect costs)	$20	
Total estimated costs	$200,000	
Fee (15%)	30,000	
Total estimated revenue	$230,000	
At the end of the first year:		
Hours used	4,000	hrs.
Estimated total hours	10,000	hrs.
Measure of progress	40%	

If the contract is completed in the second year without any changes in contract revenues and costs, the results would appear in the income statement as follows.

	First Year	*Second Year*	*Total*
Contract revenues (hours used at $20 x 115%)	$92,000	$138,000	$230,000
Contract costs (includes indirect costs)	80,000	120,000	200,000
Gross profit (15%)	$12,000	$18,000	$30,000

Exhibit C-4—Unit Price

A roadbuilder performs work primarily as a subcontractor on large highway projects. On those projects, the entity's work consists only of laying concrete. All site preparation and other work is performed by the general contractor or by subcontractors to the general contractor. The cost elements include labor and related costs, cost of expansion and contraction joints, the cost of reinforcing steel, the cost of cement and other materials, and equipment costs. The entity reports its income on the percentage-of-completion basis and measures progress toward completion on the basis of units of work completed because all costs are incurred essentially equally as square yards of concrete are laid (with the exception of mobilization and demobilization costs, which are incurred at the beginning and end of the job).

A contract sets forth 10 separate pay items, which, when totaled and converted to price per square yard of concrete, equal $12 per square yard for concrete that is to 9 inches thick. Estimated square yards of concrete to be laid approximate 450,000, and estimated total cost is $5,000,000. Costs incurred through the end

of the first year on the contract, excluding mobilization costs, total $2,200,000, which includes $100,000 of materials not used. Mobilization costs incurred total $70,000, and projected demobilization costs total $30,000. Physical output as reported by the state engineer and confirmed by the entity engineer totals 200,000 square yards at the end of the first year.

Input information (square yards of concrete poured) should not be used for determination of revenue because the entity must lay the concrete in excess of 9 inches thick to meet state requirements that concrete not be less than 9 inches thick based on test borings; thus, input in terms of cubic yards poured would exceed billable output. Accordingly, the output measure (square yards laid) is the appropriate measure of progress.

The entity's earned revenue and costs of earned revenue for the first year are computed on the following page.

Measure of progress	=	$\frac{\text{Square yards laid}}{\text{Total square yards to be laid}}$
	=	$\frac{200{,}000}{450{,}000}$
Percentage complete	=	44%
Earned revenue	=	44% x $5,400,000
	=	$2,376,000
Cost of earned revenue	=	44% x $5,000,000
	=	$2,200,000

Additional Considerations

If such a roadbuilder served as the prime contractor and performed all site preparation, sewer, and other related work, no single unit would appropriately measure progress toward completion. Some other method, such as labor hours or cost to cost, would be preferable.

If the cost-to-cost method is used, it is necessary to include the mobilization costs and to exclude the cost of the materials not used from the cost incurred in the measure of progress calculation. The computation is as follows:

Measure of progress	=	$\frac{\text{Cost incurred to date}}{\text{Estimated total cost}}$
	=	$\frac{\$2{,}200{,}000 + \$70{,}000 - \$100{,}000}{\$5{,}000{,}0000}$
Percentage complete	=	43%

Exhibit C-5—Zero Profit

A contractor has been awarded a fixed-price contract with escalation clauses for the construction of a housing project in Saudi Arabia. The contractor has no construction experience in that part of the world, and various uncertainties involving mobilization, procurement costs, and labor costs make it difficult to determine the amount of total contract revenue and costs. However, although the contractor is unable to estimate total contract costs as either a single amount or range of amounts, the terms of the contract provide protection for the contractor from incurring a loss under any reasonable circumstances. The contract price is $460,000,000.

For purposes of this illustration, it is assumed that there are no changes in estimates of contract revenues for the duration of the contract. The contractor is consistently using an acceptable measure of progress, and at the end of the first year relating to this contract, the project is considered to be 12 percent complete. Costs incurred to date are $67,200,000. Since inception, there has been no improvement in the contractor's ability to estimate total costs in terms of a single amount or range of amounts.

Following is the status of the project for accounting purposes at the end of the first year:

Earned revenue (12% of $460,000,000)	$55,200,000
Cost of earned revenue	55,200,000
Gross profit	—
Deferred costs at end of year	$12,000,000

That portion of the cost incurred to date ($67,200,000) in excess of the cost of earned revenue ($55,200,000) is reported as a deferred cost in the balance sheet.

At the end of the second year, the contractor can estimate that the total contract costs will be between $410,000,000 and $440,000,000. The measure of work completed indicated that the project is 31 percent complete at that date. Costs incurred to date are $142,400,000.

Table 1 in this appendix gives the status of the project for accounting purposes at the end of the second year. The maximum estimated costs were used in accounting for the contract. The cumulative amount of earned revenue is $142,600,000 (31 percent of $460,000,000), and the cost of earned revenue is $136,400,000 (31 percent of $440,000,000). That portion of the cost incurred to date in excess of the cost of earned revenue is reported as a deferred cost in the balance sheet.

The change from the zero profit method is a change in estimate, and the effect of the change on the second year should be disclosed. In this illustration, the effect of the change is $1,200,000, computed as follows:

At the end of the first year, using revised estimates, the effects of change are as follows:

Earned revenue, 12% of $460,000,000	$55,200,000
Cost of earned revenue, 12% of $440,000,000	52,800,000
Gross profit	$2,400,000
Gross profit recognized to date	—
Effect of change in estimate, before tax effect	$2,400,000
Tax effect, at assumed 50% rate	1,200,000
Effect of change in estimate, after tax effect	$1,200,000

Table 2 in this appendix is a summary of the contract for the first and second years and the remaining years to completion. For this purpose, it is assumed there are no subsequent changes in estimates of contract costs from the $440,000,000 maximum estimate at the end of the second year.

Table 1

	First Year	*Second Year*	*Total*
Earned revenue	$55,200,000	$87,400,000	$142,600,000
Cost of earned revenue	55,200,000	81,200,000	136,400,000
Gross profit	$—	$6,200,000	$6,200,000
Deferred costs	$12,000,000	$6,000,000	

Table 2

	First Year	*Second Year*	*Remaining Years to Completion*	*Total*
Earned revenue	$55,200,000	$87,400,000	$317,400,000	$460,000,000
Cost of earned revenue	$55,200,000	$81,200,000	$303,600,000	$440,000,000
Gross profit	$—	$6,200,000	$13,800,000	$20,000,000
Deferred costs at end of year	$12,000,000	$6,000,000	$—	$—

Exhibit C-6—Loss Contract

A contractor specializes in underground construction work. As a rule, the projects on which the contractor works take from two to three years to complete. The contractor uses the percentage-of-completion method of revenue recognition because, given the contractor's ability to estimate contract costs, revenue, and progress, it is the most appropriate method. Furthermore, the contractor's standard contract normally includes provisions that specify the enforceable rights regarding the work to be performed, consideration, and terms of settlement. Taken in combination, these factors provide a sound basis for the use of percentage-of-completion.

In year 1, the contractor obtained a contract for $1,620,000 with an estimated total cost on the project of $1,377,000 leaving an estimated gross profit of $243,000. At December 31, year 1, $500,000 had been billed, costs of $510,000 had been incurred, and estimated costs to complete were projected to be $867,000, resulting in the projected profit of $243,000. The cost to complete was determined by the job superintendent and was checked against engineering estimates of units of work completed and units of work to be completed. During year 2, the entity encountered heavy rains, worse than anticipated soil conditions, and field supervision problems. As a result of this, a loss of $60,000 was projected at the completion of the project. At December 31, year 2, billings of $1,480,000 had been made, costs of $1,545,400 had been incurred, and costs to complete were estimated at $134,800. Work under the contract is completed in year 3, and there are no further changes in contract revenues and costs. As projected in year 2, a loss of $60,000 was incurred on the contract upon completion in year 3.

Using the foregoing information, the percentage of completion is computed in the following table for both years, using the cost-to-cost method to measure progress. The cost-to-cost method is used in this situation because management

believes it provides the most accurate measure of job progress under the current contract conditions.

Year 1

Measure of progress $= \dfrac{\text{costs incurred to date}}{\text{total estimated costs}}$

$= \dfrac{\$510,000}{\$1,377,000}$

= 37%

Year 2

Measure of progress $= \dfrac{\$1,550,000}{\$1,680,000}$

= 92%

Year 3

Measure of progress $= \dfrac{\$1,680,000}{\$1,680,000}$

= 100%

The computation of earned revenue, job costs, and gross profit for income statement purposes is shown in the following tables:

	Current Year	*Total-to-Date*
Year 1 (37% completed)		
Earned revenue		
($1,620,000 x 37%)	$599,400	$599,400
Actual cost of earned revenue		
	510,000	510,000
Gross profit	$89,400	$89,400
Gross profit rate	14.9%	14.9%
Year 2 (92% completed)		
Earned revenue		
($1,620,000 x 92%)	$891,000	$1,490,400
Cost of earned revenue (See note)	1,040,400	1,550,400
Gross profit	$(149,400)	$(60,000)
Gross profit rate	(16.8%)	(4%)
Year 3 (100% completed)		
Earned revenue		
($1,620,000 x 100%)	$129,600	$1,620,000
Cost of earned revenue		
($1,620,000 x 100% plus loss)	129,600	1,680,000
Gross profit	$-0-	$(60,000)
Gross profit rate	—	(3.7%)

Note: The cost of earned revenue at the end of year 2, the year in which the estimated loss became known, is computed as follows:

Estimated total contract cost excluding estimated loss	$1,620,000
Measure of progress	x 92%
Actual cost of earned revenue before loss provision	$1,490,400
Add 100% of estimated total loss	$60,000
Cost of earned revenue at the end of year 2	$1,550,400
Less amount previously recognized	$510,000
Cost of earned revenue, year 2	$1,040,400

In accordance with paragraphs 45–50 of FASB ASC 605-35-25, a provision for the entire anticipated contract loss should be made in the period in which the loss becomes evident, which is year 2 in this example.[2]

FASB ASC 605-35-45-1 establishes that, unless the provision for loss is material in amount or unusual or infrequent in nature, it should be included in contract cost and not shown separately in the income statement; however, if the loss provision is material, it should be presented separately as a component of the cost included in the computation of gross profit, either on the face of the income statement or in the notes to the financial statements.

Exhibit C-7—Combining

A contractor who specializes in the construction of multifamily residential and commercial properties was approached by a prospective customer late in the fall to discuss the construction of a residential housing and shopping center project. They arrived at a general conceptual agreement about the nature of the work and appropriate timing and magnitude of cost estimates for the project. After the meeting, the project developer obtained the final members of the investment groups for the properties, and drawings and building specifications were then completed. The contractor was awarded the job, but under separate contracts for the apartment complex portion of the project and the shopping center. The developer explained that he or she needed separate contracts due to financing requirements and in order to maximize tax benefits for the investors.

When presented the contracts, the contractor stated that the breakdown of price between the two sections of the project was not in agreement with his or her pricing structure. However, the contractor noted that the combined contract prices resulted in a gross profit that was satisfactory to him or her. Because

[2] As an alternative to including the entirety of the anticipated loss in the normal calculation of the cost of earned revenues to date at the end of year 2, the contractor may record separately the balance of the total anticipated loss. Under this scenario, the cost of earned revenue in year 2 would be calculated normally by multiplying the total estimated contract cost by the percentage of completion on the contract: ($1,680,000) x 92% = $1,545,600. The journal entry to record the remainder of the anticipated loss would be calculated as the estimated total loss multiplied by the remaining percent complete on the contract, as follows:

	DR	*CR*
Income Statement	$4,800	
Provision for loss on uncompleted contract		
($60,000 x 8%)		
Balance Sheet		$4,800
Accrued loss on uncompleted contract		

of this and because the work on the separate phases would be performed in a relatively common time frame, he or she signed the contracts as they were prepared. Before signing the contracts, though, the contractor told the developer that it would not be practical to separate costs between the two projects because the same work crew and same machinery would be used jointly on the two phases. The contractor concluded that it would be appropriate to account for the two projects on a combined basis and report his or her financial results accordingly.

Estimated total contract revenues and costs for the two contracts are as follows:

	Apartment Project	*Shopping Center*	*Total*
Estimated contract revenue	$5,000,000	$2,000,000	$7,000,000
Estimated contract costs	4,000,000	1,800,000	5,800,000
Estimated gross profit	$1,000,000	$200,000	$1,200,000
Gross profit rate	20%	10%	17%

For purposes of this illustration, it is assumed that there are no changes in estimates of contract revenues or costs for the duration of the contracts and that the contractor uses the labor-hours method in determining percentage of completion. At the end of the first year relating to the two contracts, the following is their status:

	Apartment Project	*Shopping Center*	*Total*
Labor hours incurred to date	45,000	15,000	60,000
Estimated total contract labor hours	80,000	20,000	100,000
Measure of progress	56.25%	75%	60%
Actual contract costs	$2,250,000	$1,350,000	$3,600,000

Based on the foregoing, the recognized revenue, cost, and gross profit for the combined contract for the first fiscal year and for the second fiscal year of the contract is as follows:

	First Year	*Second Year*	*Total*
Year 1 (60% completed)			
Earned revenue			
(60% x $7,000,000)	$4,200,000		$4,200,000
Cost of earned revenue	3,600,000		3,600,000
Gross profit	$600,000		$600,000
Gross profit rate	14.3%		14.3%
Year 2 (100% complete)			
Earned Revenue			
($7,000,000 x 100%)	$4,200,000	$2,800,000	$7,000,000
Cost of earned revenue	3,600,000	2,200,000	5,800,000
Gross profit	$600,000	$600,000	$1,200,000
Gross profit rate	14.3%	21.1%	17.1%

If the contracts had not been combined, the following differences would have occurred in the revenue, costs, and gross profit reported at the end of year 1.

	Earned Revenue	*Cost of Earned Revenue*	*Gross Profit*
Apartment project (56.25% complete)	$2,812,500	$2,250,000	$562,500
Shopping center (75% complete)	1,500,000	1,350,000	150,000
Total	$4,312,500	$3,600,000	$712,500
Amounts reported under combining	$4,200,000	$3,600,000	$600,000
Difference in amounts at end of first year if contracts had not been combined	$112,500	$0	$112,500

Exhibit C-8—Segmenting

An entity specializes in the engineering, procurement of materials, and construction of chemical processing plants. The entity has been awarded one such contract, which is priced at cost, plus 10 percent allowances for indirect costs on engineering and procurement phases and a fixed fee of $225,000. The scope of the contract calls for those separable phases of the work. Contract provisions state that the fixed fee was agreed to on the basis of the following rates:

	Base Cost	*Fee Rate*	*Fee*
Engineering	$176,000	25.00%	$44,000
Procurement	44,000	2.00%	880
Construction	4,800,000	3.75%	180,120
	$5,020,000		$225,000

Estimated total contract revenue is computed as follows:

Engineering	
8000 hours at $20	$160,000
Allowance for indirect costs	16,000
Procurement	
2000 hours at $20	40,000
Allowance for indirect costs	4,000
Construction, including labor, materials, subcontract, and indirect costs	4,800,000
	$5,020,000
Fixed fee	225,000
	$5,245,000

The contractor meets the criteria for segmenting. In addition to the contract specifying the separate phases of the work, such phases are frequently contracted separately, and the contractor has a significant history of providing the engineering services to other customers separately. Such a history shows

a relatively stable pricing policy. The similarity of services and prices on the contract segments to services and the prices of such services to other customers contracted separately are documented and verifiable. In the past, the contractor's normal fees have been 15 percent on engineering, 2 percent on procurement, and 5 percent on construction. Those rates are commensurate with the different levels of risk attributable to the separate phases of the work. A comparison of the aggregate of the values of the separate phases of the contract that would have been produced from such a fee structure to the contractual fee arrangement is as follows:

		Contract Revenue	*Fee*
Engineering			
Direct costs	$160,000		
Allowance for indirect costs	16,000		
	$176,000		
Normal fee, at 15%	26,400	$202,400	$26,400
Procurement			
Direct costs	$40,000		
Allowance for indirect costs	4,000		
	$44,000		
Normal fee, at 2%	880	44,880	880
Construction (total costs)	$4,800,000		
Normal fee, at 5%	240,000	5,040,000	240,000
		$5,287,280	$267,280
Estimated total contract revenue and fee		5,245,000	225,000
Excess of the sum of the prices of the separate elements over estimated total contract revenues		$42,280	$42,280

This excess is attributable to cost savings incident to performance as a single project. The contractor segments revenues into the 3 profit centers in the manner set forth in the following table. Note that the contract-provision stipulating a 25 percent profit margin for engineering is not used because that margin is not supported by historical experience.

	Engineering	*Procurement*	*Construction*	*Total*
Normal historical fee as stated previously	$26,400	$880	$240,000	$267,280
Less reduction to reflect allocation of the excess amount in proportion to the preceding prices	(4,176)	(139)	(37,965)	(42,280)
Adjusted fee	$22,224	$741	$202,035	$225,000
Estimated total cost	176,000	44,000	4,800,000	5,020,000
Estimated total contract revenue, as adjusted	$198,224	$44,741	$5,002,035	$5,245,000

For purposes of this illustration, it is assumed that there are no changes in estimates of contract revenues, costs, and labor hours for the duration of the contract. The contractor uses the labor-hours method in determining measure of progress. Construction hours include the hours of the construction manager, the general contractor, and all subcontractors. At the end of the first year, the following is the contract status:

Profit Center	*Labor Hours Incurred to Date*	*Estimated Total Labor Hours*	*Measure of Progress*
Engineering	40,000	44,000	90.9%
Procurement	5,500	11,000	50.0%
Construction	75,000	600,000	12.5%
	120,500	655,000	18.4%

Recognized revenues, costs, and gross profit for the first fiscal period are as follows:

Profit Center	*Recognized Revenues*	*Cost Incurred*	*Gross Profit*
Engineering			
90.9% of estimated total revenues	$180,186		
Total costs		$159,984	$20,202
Procurement			
50.0% of estimated total revenues	$22,370		
Total costs		$22,000	$370
Construction			
12.5% of estimated total revenues	$625,254		
Total costs	$—	$600,000	$25,254
	$827,810	$781,984	$45,826

Assuming the contract is completed in the second fiscal period, recognized revenues, costs, and gross profit for the two fiscal periods would be as follows:

Profit Center	*Year 1*	*Year 2*	*Total*
Engineering			
Earned revenue	$180,186	$18,038	$198,224
Cost of earned revenue	159,984	16,016	176,000
Gross profit	$20,202	$2,022	$22,224
Procurement			
Earned revenue	$22,370	$22,371	$44,741
Cost of earned revenue	22,000	22,000	44,000
Gross profit	$370	$371	$741
Construction			
Earned revenue	$625,254	$4,376,781	$5,002,035
Cost of earned revenue	600,000	4,200,000	4,800,000
Gross profit	$25,254	$176,781	$202,035
Total Contract			
Earned revenue	$827,810	$4,417,190	$5,245,000
Cost of earned revenue	781,984	4,238,016	5,020,000
Gross profit	$45,826	$179,174	$225,000

If the contract had not been segmented, recognized revenues for year 1 would have been revised as follows:

Earned revenue (18.4% complete x $5,245,000)	$965,080
Costs of revenue	781,984
Gross profit without segmenting	$183,096
Gross profit under segmenting	45,826
Additional gross profit under segmenting year 1	$137,270

Appendix D

Example of Change in Accounting Estimate

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250-10-45-17 states that a change in accounting estimate should be accounted for in the period of change if the change affects that period only, or in the period of the change and future periods if the change affects both. FASB ASC 250-10-50-4 provides that the effect on income from continuing operations, net income, and any related per-share amounts of the current period should be disclosed for a change in accounting estimate that affects several future periods, such as a change in service lives of depreciable assets. Disclosure of those effects is not necessary for accounting estimates made each period in the ordinary course of accounting for items such as uncollectible accounts or inventory obsolescence; however, disclosure is required if the effect of a change in the estimate is material.

An illustrative example of the calculation and disclosure of the effects of an accounting change is as follows:

Assume, at the end of year 1:	(in thousands)
Contract revenue, at 50% complete	$50,000
Contract costs	45,000
Recognized profit	$5,000
Assume, at the end of year 2:	
Contract revenue (cumulative), at 90% complete	$105,000
Contract costs (cumulative)	90,000
Recognized profit, cumulative	$15,000
Recognized profit, year 2	$10,000

At the end of year 1, contract revenues at completion were estimated to be $100,000,000 (contract price), and contract costs at completion were estimated to be $90,000,000. However, at the end of year 2, contract revenues at completion were estimated to be $116,667,000, and contract costs were estimated to be $100,000,000. A change order agreed to in the second year added $16,667,000 to estimated total revenues and $7,000,000 to estimated total costs. Because of inefficiencies not known at the end of year 1, it was later determined that estimated total contract costs (excluding the change order) should have been $93,000,000 and that the percentage of completion should have been 48.4 percent rather than 50 percent at the end of year 1.

	Revenues (in thousands)	*Costs (in thousands)*
Change order (agreed to in second year)	$16,667	$7,000
Revised estimate (made after change order)		3,000
Estimates of revenues and cost at completion—year 1	100,000	90,000
Estimates of revenues and costs at completion—year 2	$116,667	$100,000

The calculation of the effects of the changes in estimates on year 2 net income follows. The effect of the change order is excluded from the calculation because it is clearly a year 2 event. However, in most circumstances, change orders would not have to be eliminated because their effect would be immaterial.

	(in thousands)
At the end of year 1, using revised estimates:	
Contract revenues (original contract)	$100,000
Contract costs (original contract)	93,000
Estimated total profit	$7,000
Percent complete (revised estimate)	48.4
Recognizable profit	$3,388
Profits recognized originally	5,000
Effect of change in estimate, before income taxes	$1,612
Income taxes at 50%	806
Effect of change in estimate	$806

The following is an example of disclosure of the effect of this change:

> Revisions in estimated contract profits are made in the year in which circumstances requiring the revision become known. The effect of changes in estimates of contract profits was to decrease net income of 19X2 by $806,000 ($.12 per share, net of income tax) from that which would have been reported had the revised estimate been used as the basis of recognition of contract profits in the preceding year.

Appendix E

Sample Financial Statements Percentage Contractors, Inc.*, †

The following sample financial statements of a construction contractor are included for illustrative purposes only and are not intended to establish reporting requirements. Furthermore, the dollar amounts shown are illustrative only and are not intended to indicate any customary relationship among accounts. The sample financial statements do not include all of the accounts and transactions that might be found in practice. The notes indicate the subject matter generally required to be disclosed, but they should be expanded, reduced, or modified to suit individual circumstances or materiality considerations. In addition to the illustrative notes that are presented, some of which are more or less peculiar to construction contractors, the notes to a construction contractor's financial statements should include information concerning other matters that are not unique to construction contractors, for example, subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, stock options, lease commitments, extraordinary items, accounting changes, off-balance-sheet risks.

Independent Auditor's Report

The Shareholders and Board of Directors
Percentage Contractors, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Percentage Contractors, Inc., and Subsidiaries (the Company) as of December 31, 20X1 and 20X0, and the related consolidated statements of income and retained earnings and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan

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* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

† The illustrative financial statements and footnote disclosures included in this guide have been updated to reflect the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC). However, FASB's notice to constituents suggests the use of plain English in financial statement footnotes to describe broad FASB ASC topic references. FASB suggests a reference similar to "as required by the Derivatives and Hedging Topic of the FASB *Accounting Standards Codification*." Entities might consider revising their financial statement references to reflect this plain English referencing, rather than the use of specific FASB ASC references. We have provided these detailed references as a resource for our users.

[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." Refer to the PCAOB website at www.pcaobus.org for the full text of PCAOB Auditing Standards.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), which provides

(continued)

and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.*][2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements previously referred to present fairly, in all material respects, the financial position of Percentage Contractors, Inc., and Subsidiaries as of [at] December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

(*Firm Signature*)
Certified Public Accountants

City, State

February 18, 20X2

Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (PCAOB), the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for direction about reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of Auditing Standard No. 5, which include an illustrative

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(footnote continued)

reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB Auditing Standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB auditing standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AuditingStandardsBoard/DownloadableDocuments/ASB%20Timetable.pdf for more information.

[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88). Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

combined audit report. If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements in accordance with paragraph 88 of Auditing Standard No. 5:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), X company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

When issuing separate reports on the company's financial statements and on internal control over financial reporting, the auditor also should add the following paragraph to the report on internal control over financial reporting in accordance with paragraph 88 of Auditing Standard No. 5:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of X company and our report dated [*date of report*] expressed [*include nature of opinion*].

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, paragraph 89 of Auditing Standard No. 5 states that the auditor's report on the company's financial statements and on internal control over financial reporting should be dated the same date.

Percentage Contractors, Inc.
Consolidated Balance Sheets
December 31, 20X1 and 20X0

Assets	*20X1*	*20X0*	*Liabilities and Shareholders' Equity*	*20X1*	*20X0*
Cash and cash equivalents	$304,400	$221,300	Current maturities of notes payable (note 9)	$110,300	$110,300
Contracts receivables (notes 1 and 3)	3,789,200	3,334,100	Current portion of lease obligations payable (note 10)	62,250	57,250
Costs and estimated earnings in excess of billings on uncompleted contracts (note 4)	156,900	100,600	Accounts payable (note 8)	2,543,100	2,588,500
Inventory	89,700	99,100	Billings in excess of costs and estimated earnings on uncompleted contracts (note 4)	242,000	221,700
			Accrued loss on uncompleted contract	76,600	
Prepaid charges and other assets	118,400	83,200	Other accrued liabilities	88,600	114,600
Total current assets	4,458,600	3,838,300	Total current liabilities	3,122,950	3,092,350
			Notes payable, less current maturities (note 9)	357,800	468,100
			Lease obligations payable, less current portion (note 10)	135,350	194,050
Advances to and equity in joint venture (note 5)	205,600	130,700	Due to consolidated joint venture noncontrolling interests	154,200	26,200
Note receivable, related company (note 6)	175,000	150,000	Deferred tax liability (note 13)	619,200	408,000
			Total long term liabilities	1,266,550	1,096,350
Property and equipment, net of accumulated depreciation and amortization (note 7)	976,400	1,019,200	Total liabilities	4,389,500	4,188,700
	1,357,000	1,299,900			
Total assets	$5,815,600	$5,138,200	Contingent liability (note 14)		
			Shareholders' equity		
			Common stock — $1 par value, 500,000 authorized shares, 300,000 issued and outstanding shares	300,000	300,000
			Retained earnings	1,126,100	649,500
			Total shareholders' equity	1,426,100	949,500
			Total liabilities and shareholders' equity	$5,815,600	$5,138,200

The accompanying notes are an integral part of these consolidated financial statements.

Percentage Contractors, Inc.
Consolidated Statements of Income[3] and Retained Earnings
Years Ended December 31, 20X1 and 20X0

	20X1	*20X0*
Contract revenues earned	$22,630,800	$16,225,400
Cost of revenues earned	20,436,100	14,951,300
Gross profit	2,194,700	1,274,100
Selling, general, and administrative expense	895,600	755,600
Income from operations	1,299,100	518,500
Other income (expense)		
Equity in earnings from unconsolidated joint venture	49,900	5,700
Gain on sale of equipment	10,000	2,000
Interest expense (net of interest income of $8,800 in 20X1 and $6,300 in 20X0)	(69,500)	(70,800)
Total other expense	(9,600)	(63,100)
Income before provision of income taxes	1,289,500	455,400
Provision for income taxes (note 13)	662,900	225,000
Net income	626,600	230,400
Basic and diluted earnings per share[4]	2.09	.77

(*continued*)

[3] FASB ASC 220, *Comprehensive Income*, establishes standards for the reporting and display of comprehensive income and its components. The guidance requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The guidance does not require a specific format for that financial statement but requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement. FASB ASC 323-10-35-18 addresses the recording of an investor's share of the investee's other comprehensive income. FASB ASC 220 does not apply to an enterprise that has no items of other comprehensive income in any period presented.

[4] FASB ASC 260, *Earnings Per Share*, requires presentation of earnings per share by all entities that have issued common stock or potential common stock if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. The guidance also requires presentation of earnings per share by an entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of those securities in a public market.

In August 2008, FASB issued a revised exposure draft of a proposed statement titled *Earnings per Share—an amendment of FASB Statement No. 128*. This proposed statement would amend the computational guidance in FASB Statement No. 128, *Earnings Per Share*, as codified in FASB ASC 260, for calculating the number of incremental shares included in diluted shares when applying the treasury stock method. Also, this proposed statement would eliminate the provisions of FASB Statement No. 128, as codified in FASB ASC 260, that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert to the issuance of the final standard.

In December 2004, FASB issued FASB Statement No. 123 (revised 2004), *Share-Based Payment*, primarily codified in FASB ASC 718, *Compensation—Stock Compensation*, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Additionally, in March 2005, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*. SAB No. 107 expresses views of the SEC staff regarding the application of FASB Statement No. 123(R), primarily codified in FASB ASC 718, by public companies, and provides interpretive guidance related to the interaction between FASB Statement No. 123(R), primarily codified in FASB ASC 718, and certain SEC rules and regulations.

Percentage Contractors, Inc.
Consolidated Statements of Income and Retained Earnings
Years Ended December 31, 20X1 and 20X0

	20X1	*20X0*
Retained earnings, beginning of year	649,500	569,100
	1,276,100	799,500
Less: Dividends paid (per share $.50 (20X1); $.50 (20X0))	150,000	150,000
Retained earnings, end of year	$1,126,100	$649,500

The accompanying notes are an integral part of these consolidated financial statements.

Percentage Contractors, Inc.
Consolidated Statements of Cash Flows (Indirect Method)
Years Ended December 31, 20X1 and 20X0

	Years Ended December 31,	
	20X1	*20X0*
Cash flows from operating activities:		
Net income	$626,600	$230,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	167,800	153,500
Provision for losses on contract receivables	6,300	1,100
Gain on sale of equipment	(10,000)	(2,000)
Increase (decrease) in deferred taxes	211,200	(75,900)
Equity earnings from unconsolidated joint venture	(49,900)	(5,700)
Increase in joint venture noncontrolling interest	128,000	26,200
Increase in contract receivables	(461,400)	(10,200)
Net increase in billings related to costs and estimated earnings on uncompleted contracts	36,000	10,500
Decrease (increase) in inventory	9,400	(3,600)
Decrease (increase) in prepaid charges and other assets	(35,200)	16,100
Increase (decrease) in accounts payable	(45,400)	113,200
Increase in accrued loss on uncompleted contract	76,700	
Increase (decrease) in other accrued liabilities	(26,000)	18,800
Net cash provided by operating activities	562,100	472,400
Cash flows from investing activities:		
Proceeds of equipment sold	25,000	5,000
Acquisition of equipment	(140,000)	(175,000)
Advances to joint venture	(25,000)	(9,700)
Advances on note receivable related company	(25,000)	(50,000)
Net cash used in investing activities	(165,000)	(229,700)
Cash flows from financing activities:		
Principal payments on notes payable	(110,300)	(90,300)
Principal payments under capital lease obligations	(53,700)	(9,700)
Cash dividends paid	(150,000)	(150,000)
Net cash used in financing activities	(314,000)	(250,000)
Net increase (decrease) in cash and cash equivalents	83,100	(7,300)
Cash and cash equivalents at beginning of year	221,300	228,600
Cash and cash equivalents at end of year	$304,400	$221,300

Supplemental data:

Cash equivalents include certificates of deposit with original maturities of one to three months—

Interest paid—20X1, $73,500; 20X0, $75,100

Income taxes paid—20X1, $478,300; 20X0, $313,200

The accompanying notes are an integral part of these consolidated financial statements.

Percentage Contractors, Inc.
Notes to Consolidated Financial Statements
December 31, 20X1 and 20X2

1. Nature of Operations and Significant Accounting Policies[5]

Nature of operations. The Company is engaged in the construction of industrial and commercial buildings primarily in the Southwestern region of the United States. The Company's work is performed under cost-plus-fee contracts, fixed-price contracts, and fixed-price contracts modified by incentive and penalty provisions. These contracts are undertaken by the Company or its wholly owned subsidiary alone or in partnership with other contractors through joint ventures. The Company also manages, for a fee, construction projects of others. The length of the Company's contracts varies but is typically about two years. The Company follows the practice of filing statutory liens on all construction projects when collection problems are anticipated. The liens serve as collateral for contracts receivable.

Significant Accounting Policies

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Balance sheet classification. The Company includes in current assets and liabilities retainage amounts receivable and payable under construction contracts, which may extend beyond one year. A one-year time period is used as the basis for classifying all other current assets and liabilities.

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[5] On June 30, 2009, FASB issued FASB Statement No. 168, *The FASB* Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, which is codified in FASB ASC 105, *Generally Accepted Accounting Principles*. On the effective date of this statement, FASB ASC became the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. At that time, FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC became nonauthoritative. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

Principles of consolidation.[6,‡] The consolidated financial statements include the Company's majority-owned entities, a wholly owned corporate subsidiary and a 75 percent-owned joint venture (a partnership). All significant intercompany transactions are eliminated. The Company has a noncontrolling interest in a joint venture (partnership), which is reported on the equity method.

Cash and cash equivalents. For purposes of reporting cash flows, the Company considers all highly liquid investments purchased with an original maturity of three months or less as cash and cash equivalents in the accompanying consolidated balance sheets.

Contracts receivable. Contracts receivable from performing construction of industrial and commercial buildings are based on contracted prices. The Company provides an allowance for doubtful collections, which is based upon a

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[6] In January 2010, FASB issued Accounting Standards Update (ASU) No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. ASU No. 2010-02 provides amendments to FASB ASC 810-10 and related guidance within U.S. generally accepted accounting principles (U.S. GAAP) to clarify that the scope of the decrease in ownership provisions of the subtopic and related guidance applies to the following:

a. A subsidiary or group of assets that is a business or nonprofit activity

b. A subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture

c. An exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture)

The amendments in this ASU also clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to (*a*) sales of in substance real estate and (*b*) conveyances of oil and gas mineral rights, even if these transfers involve businesses.

The amendments in this ASU expand the disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASU 810-10. In addition to existing disclosures, an entity should disclose the following for such a deconsolidation or derecognition:

a. The valuation techniques used to measure the fair value of any retained investment in the former subsidiary or group of assets and information that enables users of its financial statements to assess the inputs used to develop the measurement

b. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized

c. Whether the transaction that resulted in the deconsolidation of the subsidiary or the derecognition of the group of assets was with a related party or whether the former subsidiary or entity acquiring the group of assets will be a related party after deconsolidation

The entity also should disclose the valuation techniques used to measure an equity interest in an acquiree held by the entity immediately before the acquisition date in a business combination achieved in stages.

The amendments are effective beginning in the period that an entity adopts FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB 51*, as codified in FASB ASC 810-10. If an entity has previously adopted FASB Statement No. 160, the amendments are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in ASU No. 2010-02 should be applied retrospectively to the first period that an entity adopts FASB Statement No. 160.

[‡] In December 2009, FASB issued ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. ASU No. 2009-17 represents a revision to former FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51*, and changes how a reporting entity determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity's purpose and design and the reporting entity's ability to direct the activities of the other entity that most significantly impact the other entity's economic performance.

ASU No. 2009-17 requires a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. The reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity's financial statements. ASU No. 2009-17 is effective for annual periods beginning after November 15, 2009, and interim periods within those fiscal years. Readers should see transition guidance located at FASB ASC 810-10-65-2 for additional effective date information regarding disclosures. Early adoption is not permitted.

review of outstanding receivables, historical collection information, and existing economic conditions. Normal contracts receivable are due 30 days after the issuance of the invoice. Contract retentions are due 30 days after completion of the project and acceptance by the owner. Receivables past due more than 120 days are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

Inventory. Inventory consisting of building materials is stated at the lower of cost (first in, first out method) or market.

Property and equipment. Property and equipment are stated at cost. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets, which range from 5 to 39 years. Leasehold improvements are amortized over the shorter of the useful life of the related assets or the lease term. Expenditures for repairs and maintenance are charged to expense as incurred. For assets sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any related gain or loss is reflected in income for the period.

Impairment of long-lived assets. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of these assets is determined by comparing the forecasted undiscounted net cash flows of the operation to which the assets relate to the carrying amount. If the operation is determined to be unable to recover the carrying amount of its assets, then assets are written down first, followed by other long-lived assets of the operation to fair value. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the assets. As of December 31, 20X1 and 20X0, there were no impairment losses recognized for long-lived assets.

Revenue and cost recognition. Revenues from fixed price construction contracts are recognized on the percentage of completion method, measured on the basis of incurred costs to estimated total costs for each contract. This cost to cost method is used because management considers it to be the best available measure of progress on these contracts. Revenues from cost-plus fee contracts are recognized on the basis of costs incurred during the period plus the fee earned, measured by the cost to cost method.

Contracts to manage, supervise, or coordinate the construction activity of others are recognized only to the extent of the fee revenue. The revenue earned in a period is based on the ratio of hours incurred to the total estimated hours required by the contract.

Contract costs include all direct material and labor costs and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. Selling, general, and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Changes in job performance, job conditions, and estimated profitability, including those arising from contract penalty provisions, and final contract settlements may result in revisions to costs and income and are recognized in the period in which the revisions are determined. Profit incentives are included in revenues when their realization is reasonably assured. An amount equal to contract costs attributable to claims is included in revenues when realization is probable and the amount can be reliably estimated.

The asset, "costs and estimated earnings in excess of billings on uncompleted contracts," represents revenues recognized in excess of amounts billed. The liability, "billings in excess of costs and estimated earnings on uncompleted contracts," represents billings in excess of revenues recognized.

Union-sponsored pension plan. The Company participates in a union-sponsored pension plan, which covers union employees. Contributions to the plan are based on a fixed rate per hour worked. Pension expense under this plan was $550,000 and $500,000 for the years ended December 31, 20X1 and 20X0, respectively.

Governmental regulations impose certain requirements relative to union-sponsored pension plans. In the event of plan termination or employer withdrawal, an employer may be liable for a portion of the plan's unfunded vested benefits. The Company has not received information from the plans' administrators to determine its share of unfunded vested benefits. The Company does not anticipate withdrawal from the plans, nor is the Company aware of any expected plan terminations.

Income taxes. Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the consolidated financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled as prescribed in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740, *Income Taxes*. As changes in tax laws or rate are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Construction contracts are reported for tax purposes on the completed-contract method and for financial statement purposes on the percentage-of-completion method. Accelerated depreciation is used for tax reporting, and straight-line depreciation is used for financial statement reporting.

Business tax credits are applied as a reduction to the current provision for federal income taxes using the flow-through method.

If it is probable that an uncertain tax position will result in a material liability and the amount of the liability can be estimated, then the estimated liability is accrued. If the Company were to incur any income tax liability in the future, interest on any income tax liability would be reported as interest expense, and penalties on any income tax would be reported as income taxes. The open tax years are 20XX–20XX for U.S. federal, state, and local jurisdictions. As of December 31, 20X1, no uncertain tax positions existed.

Subsequent events. The Company has performed a review of events subsequent to the balance sheet date through February 18, 20X2, the date the consolidated financial statements were available to be issued.

Basic earnings per common share. Basic earnings per common share were computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the year. Diluted earnings per share are not presented because the Company has issued no dilutive potential common shares.

2. Fair Value of Financial Instruments[7,8,9,10,||]

The carrying amounts of the Company's cash and cash equivalents, note receivable, and lease obligations payable approximate their fair value. The fair value of the Company's notes payable is estimated at $490,500 based on the future cash flows associated with each note discounted using the Company's current borrowing rate for similar debt.

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[7] In September 2006, FASB issued FASB Statement No. 157, *Fair Value Measurements*, as codified in FASB ASC 820, *Fair Value Measurements and Disclosures*, which defines *fair value*, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements, but the application of it will change current practice. Refer to chapter 2, "Accounting for Performance of Construction-Type Contracts," for additional discussion of this statement, including information pertaining to the effective date.

In February 2007, FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, as codified in FASB ASC 825, *Financial Instruments*, which permits all entities, including not-for-profit organizations, to choose to measure eligible items at fair value at specified election dates. Notable eligible items include recognized financial assets and financial liabilities (except for those specifically prohibited), written loan commitments, and rights and obligations under a warranty that is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash payment) but whose terms permit the insurer to settle by paying a third party to provide those goods or services. Entities shall report assets and liabilities that are measured at fair value pursuant to the fair value option in this statement in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. Refer to chapter 2 for additional discussion of this statement, including information pertaining to the effective date.

[8] FASB ASC 825-10-50-3 notes that for annual reporting periods, the disclosures about fair value of financial instruments prescribed in FASB ASC 825-10 are optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815, *Derivatives and Hedging*, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

[9] AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. Please refer to chapter 9, "Planning the Audit, Assessing and Responding to Audit Risk, and Additional Auditing Considerations," for a discussion of AU section 328.

[10] In September 2009, FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. ASU No. 2009-12 provides guidance on using the net asset value per share provided by investees to estimate the fair value of an alternative investment. ASU No. 2009-12 provides amendments to FASB ASC 820 for the fair value measurement of investments in certain entities that calculate net asset value per share and requires disclosures by major category of investments about the attributes of those investments. Readers should consult ASU No. 2009-12 for further guidance.

ASU No. 2009-12 requires disclosures by major category of investment about the attributes of investments within the scope of ASU No. 2009-12. ASU No. 2009-12 is effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. If an entity early adopts the measurement amendments of ASU No. 2009-12, the entity is permitted to defer the adoption of the disclosure provisions of paragraph 6A of FASB ASC 820-10-50 until periods ending after December 15, 2009. Refer to chapter 2 for additional discussion of this ASU.

This guidance is located in FASB ASC 820-10-15, FASB ASC 820-10-35, FASB ASC 820-10-50, and FASB ASC 820-10-55 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 820-10-65-6. Refer to chapter 2 for additional discussion of this ASU.

[||] In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU No. 2010-06 provides amendments to FASB ASC 820-10 that require new disclosures as follows:

(continued)

3. Contracts Receivable

	December 31, 20X1	December 31, 20X0
Contracts receivable		
Billed		
Completed contracts	$621,100	$500,600
Contracts in progress	2,146,100	1,931,500
Retained	976,300	866,200
Unbilled	121,600	105,400
	3,865,100	3,403,700
Less: Allowances for doubtful collections	75,900	69,600
	$3,789,200	$3,334,100

The total recorded investment in impaired contracts receivable recognized in accordance with paragraphs 20–29 of FASB ASC 310-10-35 was $125,000 in 20X1 and $103,000 in 20X0. These amounts also approximate the average recorded investment in impaired contracts receivable during the related periods. The allowance for credit losses associated with these receivables was $41,000 in 20X1 and $38,000 in 20X0. It is management's policy not to accrue interest income on impaired contracts receivable given past difficulties in collecting such amounts. Interest income on impaired contracts receivable of $1,452 and $1,107 was recognized for cash payments received in 20X1 and 20X0, respectively. For impairment recognized in conformity with paragraphs 20–29 of FASB ASC 310-10-35, the entire change in present value of expected cash flows is reported as bad debt expense in the same manner in which impairment initially was recognized or as a reduction in the amount of bad debt expense that otherwise would be reported.

(footnote continued)

a. Transfers in and out of levels 1 and 2. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.

b. Activity in level 3 fair value measurements. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

ASU No. 2010-06 further provides amendments to FASB ASC 820-10 that clarify existing disclosures as follows:

a. Level of disaggregation. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.

b. Disclosures about inputs and valuation techniques. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and on recurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

ASU No. 2010-06 also includes conforming amendments to the guidance on employers' disclosures about postretirement benefit plan assets (FASB ASC 715-20). The conforming amendments to FASB ASC 715-20 change the terminology from major categories of assets to classes of assets and provide a cross reference to the guidance in FASB ASC 820-10 on how to determine appropriate classes to present fair value disclosures.

The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Refer to chapter 2 for additional discussion of this ASU.

Analysis of the changes in the allowance for doubtful collections.

	20X1	*20X0*
Balance at January 1	$69,600	$68,000
Additions charged to operations	6,300	1,100
Direct write-downs	—	500
Recoveries	—	—
Balance at December 31	$75,900	$69,600

Contracts receivable at December 31, 20X1, include a claim, expected to be collected within one year, for $290,600 arising from a dispute with the owner over design and specification changes in a building currently under construction. The changes were made at the request of the owner to improve the thermal characteristics of the building and, in the opinion of counsel, gave rise to a valid claim against the owner.

The retained and unbilled contracts receivable at December 31, 20X1, included $38,600 that was not expected to be collected within one year.

Contracts receivable include approximately $800,000 due under one contract.[11]

4. Costs and Estimated Earnings on Uncompleted Contracts

Following is a summary of contracts in progress at December 31, 20X1 and 20X0:

	December 31, 20X1	*December 31, 20X0*
Costs incurred on uncompleted contracts	$15,346,500	$12,165,400
Estimated earnings	1,762,600	1,246,800
	17,109,100	13,412,200
Less: Billings to date	17,194,200	13,533,300
	$(85,100)	$(121,100)
These amounts are included in accompanying consolidated balance sheets under the following captions:		
Costs and estimated earnings in excess of billings on uncompleted contracts	$156,900	$100,600
Billings in excess of costs and estimated earnings on uncompleted contracts	(242,000)	(221,700)
	$(85,100)	$(121,100)

[11] FASB ASC 825 requires disclosure of concentrations of credit risks of all financial instruments. Concentrations can be geographical areas, types of contracts, owners or others. Additionally, the contractor should disclose, for each significant concentration, the policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the contractor's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

5. Advances to and Equity in Joint Venture

The Company has a noncontrolling interest (one-third) in a general partnership joint venture formed to construct an office building. All of the partners participate in construction, which is under the general management of the Company. Summary information on the joint venture follows.

	December 31, 20X1	*December 31, 20X0*
Current assets	$483,100	$280,300
Construction and other assets	220,500	190,800
	703,600	471,100
Less: Liabilities	236,800	154,000
Net assets	$466,800	$317,100
Revenue	$3,442,700	$299,400
Net income	$149,700	$17,100
Company's interest		
Share of net income	$49,900	$5,700
Advances to joint venture	$50,000	$25,000
Equity in net assets	155,600	105,700
Total advances and equity	$205,600	$130,700

(For the purposes of illustrative financial statements, the one-line equity method of presentation is used in both the balance sheet and the income statement. However, the pro rata consolidation method is acceptable if the investment is deemed to represent an undivided interest.)

6. Transactions With Related Party

The note receivable, related company, is an installment note bearing annual interest at 9 percent, payable quarterly, with the principal payable in annual installments of $25,000, commencing October 1, 20X3.

The major stockholder of the Company owns the majority of the outstanding common stock of this related company, whose principal activity is leasing land and buildings. Percentage Contractors, Inc., rents land and office facilities from the related company on a 10-year lease ending September 30, 20X9, for an annual rental of $19,000.

7. Property and Equipment

	December 31, 20X1	December 31, 20X0
Assets		
Land	$57,500	$7,500
Buildings	262,500	262,500
Shop and construction equipment	827,600	727,600
Automobiles and trucks	104,400	89,100
Leased equipment under capital leases	300,000	300,000
	1,552,000	1,436,700
Accumulated depreciation and amortization		
Buildings	140,000	130,000
Shop and construction equipment	265,600	195,500
Automobiles and trucks	70,000	42,000
Leased equipment under capital leases	100,000	50,000
	575,600	417,500
Net property and equipment	$976,400	$1,019,200

Note: FASB ASC 360, *Property, Plant, and Equipment*, requires certain disclosures if an impairment loss is recognized for assets to be held and used. An example of such a disclosure is shown in the following paragraph:

> *Recently adopted environmental legislation has placed significant restrictions on the use of certain heavy equipment owned and operated by the company. This circumstance has called into question the recoverability of the carrying amounts of these assets. As a result, pursuant to the provisions of FASB ASC 360,* Property, Plant, and Equipment*, an impairment loss of $X,XXX has been recognized for this equipment and included as a component of income before income taxes under the caption "Selling, general and administrative expenses." In calculating the impairment loss fair value was determined by reviewing quoted market prices for current sales of similar equipment.*

8. Accounts Payable

Accounts payable include amounts due to subcontractors, totaling $634,900 at December 31, 20X1, and $560,400 at December 31, 20X0, which have been retained pending completion and customer acceptance of jobs. Accounts payable at December 31, 20X1, include $6,500 that is not expected to be paid within one year.

9. Financing Activities

Line of credit. The Company has a line of credit agreement with a bank of $1,500,000. There were no borrowings against the line at December 31, 20X1 and 20X0. The line bears interest at the bank's prime lending rate. The line is reviewed annually and is due on demand. Under terms of the line of credit, the Company is required to maintain a specified debt service coverage ratio and debt to tangible net worth ratio, as those terms are defined.

Notes payable. Following is a summary of all notes payable:

	December 31, 20X1	*December 31, 20X0*
Unsecured note payable to bank, due in quarterly installments of $22,575 plus interest at 1% over prime	$388,100	$478,400
Note payable to bank, collateralized by equipment, due in monthly installments of $1,667 plus interest at 10% through January 20X6	80,000	100,000
	$468,100	$578,400
Current maturities	110,300	110,300
	$357,800	$468,100

Principal payments on note payables are due as follows.

Year ending December 31,

20X2	$110,300
20X3	$110,300
20X4	$110,300
20X5	$110,300
20X6	$26,900

10. Lease Obligations Payable

The Company leases certain specialized construction equipment under leases classified as capital leases. The following is a schedule showing the future minimum lease payments under capital leases by years and the present value of the minimum lease payments as of December 31, 20X1.

Year ending December 31	
20X2	$76,500
20X3	76,500
20X4	76,500
Total minimum lease payments	229,500
Less: Amount representing interest	31,900
Present value of minimum lease payments	$197,600

At December 31, 20X1, the present value of minimum lease payments due within one year is $62,250.

Total rental expense, excluding payments on capital leases, totaled $86,300 in 20X1 and $74,400 in 20X0.

11. Surety Bonds

The Company, as a condition for entering into some of its construction contracts, had outstanding surety bonds as of December 31, 20X1 and 20X0. The surety bonds are collateralized by the contracts receivable and personally guaranteed by the stockholders of the Company.

12. Management Contracts

The Company manages or supervises commercial and industrial building contracts of others for a fee. These fees totaled $121,600 in 20X1 and $1,700 in 20X0 and are included in contract revenues earned.

13. Income Taxes and Deferred Income Taxes[12,13]

The provision for taxes on income consists of the following.

	December 31, 20X1	*December 31, 20X0*
Current	$451,700	$300,900
Deferred	211,200	(75,900)
Total	$662,900	$225,000

[12] In addition to the information presented, FASB ASC 740, *Income Taxes*, requires that a public enterprise disclose a reconciliation using percentages or dollar amounts of (*a*) the reported amount of income tax expense attributable to continuing operations for the year to (*b*) the amount of income tax expense that would result from applying domestic federal statutory tax rates to pretax income from continuing operations. The statutory tax rates shall be the regular tax rates if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item shall be disclosed. A nonpublic enterprise shall disclose the nature of significant reconciling items but may omit a numerical reconciliation.

The guidance in FASB ASC 740 applies to all entities that prepare financial statements in accordance with GAAP. FASB ASC 740 establishes, among other matters, a recognition threshold defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized. FASB ASC 740 requires that an analysis of all material tax positions be done as of each reporting date and prescribes separate reporting of (*a*) the deferred tax balance, based on the sustainable book or tax differences, or both, pursuant to the model adopted by this interpretation, and (*b*) the liability for any unrecognized benefit. FASB ASC 740 states that the use of a valuation allowance is not an appropriate way to recognize this type of liability. Additional guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition is also provided.

[13] In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. The amendments in ASU No. 2009-06 provide implementation guidance, through examples, to address questions regarding how to apply the standards for uncertainty in income taxes. In addition, the amendments eliminate the disclosures required by paragraphs 15(a)–(b) of FASB ASC 740-10-50. FASB ASC 740-10-50-15(a) requires a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented. FASB ASC 740-10-50-15(b) requires the disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. For entities that are currently applying the standards for accounting for uncertainty in income taxes, the guidance and disclosure amendments are effective for financial statements issued for interim and annual periods ending after September 15, 2009. For those entities that have deferred the application of accounting for uncertainty in income taxes in accordance with FASB ASC 740-10-65-1(e), the guidance and disclosure amendments are effective upon adoption of those standards. FASB ASC 740-10-65-1(e) notes that the effective date for FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, for entities meeting the conditions of and electing to use the deferral in FASB Staff Position FIN 48-3, *Effective Date of FASB Interpretation No. 48 for Certain Nonpublic Enterprises*, is for annual financial statements for fiscal years beginning after December 15, 2008.

The following represents the approximate tax effect of each significant type of temporary difference giving rise to the deferred income tax liability.

	December 31, 20X1	*December 31, 20X0*
Deferred tax asset:		
Employee benefits	$44,300	$38,100
Other	10,100	10,600
Total	$54,400	$48,700
Deferred tax liability:		
Earnings on uncompleted contracts	$594,000	$389,800
Property, plant, and equipment	64,300	54,100
Other	15,300	12,800
Total	$673,600	$456,700
Deferred tax liability, net	$619,200	$408,000

14. Contingencies

From time to time, the Company is involved in routine litigation that arises in the ordinary course of business. There are no pending significant legal proceedings to which the Company is a party for which management believes the ultimate outcome would have a material adverse effect on the Company's financial position.

The Company is contingently liable to a surety company under a general indemnity agreement. The Company agrees to indemnify the surety for any payments made on contracts of surety ship, guaranty, or indemnity. The Company believes that all contingent liabilities will be satisfied by their performance on the specific bonded contracts.

15. Backlog

The following schedule shows a reconciliation of backlog representing the amount of revenue the Company expects to realize from work to be performed on uncompleted contracts in progress at December 31, 20X1 and 20X0, and from contractual agreements on which work has not yet begun.[14]

Contract revenues on uncompleted contracts at December 31, 20X0	$24,142,600
Contract adjustments	1,067,100
Contract revenues for new contracts, 20X1	3,812,200
	29,021,900
Less: Contract revenue earned, 20X1	22,630,800
Backlog at December 31, 20X1	$6,391,100

In addition, between January 1, 20X2, and February 18, 20X2, the Company entered into additional construction contracts with revenues of $5,332,800.

[14] The presentation of backlog information, although encouraged, is not a required disclosure.

Appendix F

*Sample Accompanying Information**

Percentage Contractors, Inc.

Independent Auditor's Report on Accompanying Information

The Shareholders and Board of Directors
Percentage Contractors, Inc. and Subsidiaries

We have audited the consolidated financial statements of Percentage Contractors, Inc. and Subsidiaries as of and for the years ended December 31, 20X1 and 20X0, and have issued our report thereon dated February 18, 20X2, which contained an unqualified opinion on those consolidated financial statements. Our audit was performed for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary information is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information is the responsibility of management and was derived from, and related directly to, the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally

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* In February 2010, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550); SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551); and SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558). These SASs amend or supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*; AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*), respectively. Collectively, these statements address the auditor's responsibilities with respect to information that is required by a designated standard setter (that is, the Financial Accounting Standards Board [FASB], Governmental Accounting Standards Board, Federal Accounting Standards Advisory Board, and the International Accounting Standards Board) to accompany an entity's basic financial statements and supplementary information that is presented outside the basic financial statements. The effective date of the SASs is for audits of financial statements for periods beginning on or after December 15, 2010, and early application is permitted.

The exhibit in SAS No. 119 provides the following example of an explanatory paragraph that the auditor may use when engaged to report on supplementary information in relation to the financial statements as a whole and the auditor is issuing an unqualified opinion on the financial statements and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole:

> Our audit was conducted for the purpose of forming an opinion on the financial statements as a whole. The [*identify accompanying supplementary information*] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the financial statements as a whole.

accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

(*Firm Signature*)
Certified Public Accountants

City, State

February 18, 20X2

Percentage Contractors, Inc.

Schedule 1

Earnings From Contracts

Year Ended December 31, 20X1

			20X1	*20X0*
	Revenues earned	*Cost of revenues earned*	*Gross profit (loss)*	*Gross profit (loss)*
Contracts completed during the year	$6,290,800	$5,334,000	$956,800	$415,300
Contracts in progress at year-end	16,218,400	14,636,900	1,581,500	921,400
Management contract fees earned	121,600	51,800	69,800	1,700
Provision for loss on uncompleted contract		76,700	(76,700)	
Unallocated indirect and warranty costs[1]		46,700	(46,700)	(38,100)
Minority interest in joint venture		128,000	(128,000)	(26,200)
Charges on prior year contracts		162,000	(162,000)	
	$22,630,800	$20,436,100	$2,194,700	$1,274,100

[1] FASB *Accounting Standards Codification* (ASC) 460, *Guarantees*, elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Product warranties are excluded from the initial recognition and initial measurement requirements; however, the disclosure requirements described in paragraphs 6 and 8 of FASB ASC 460-10-50 are applicable.

Percentage Contractors, Inc.
Schedule 2
Contracts Completed
Year Ended December 31, 20X1

Contract		*Contract totals*			*Before January 1, 20X1*			*During the year ended December 31, 20X1*		
Number	*Type*	*Revenues earned*	*Cost of revenues*	*Gross profit (loss)*	*Revenues earned*	*Cost of revenues*	*Gross profit (loss)*	*Revenues earned*	*Cost of revenues*	*Gross profit (loss)*
1511	B	$5,475,300	$4,802,500	$672,800	$3,223,400	$2,932,700	$290,700	$2,251,900	$1,869,800	$382,100
1605	A	695,000	880,900	(185,900)	596,100	558,100	38,000	98,900	322,800	(223,900)
1624	A	140,700	150,700	(10,000)	29,600	31,800	(2,200)	111,100	118,900	(7,800)
1711	A	2,725100	2,391,700	333,400	1,654,100	1,510,000	144,100	1,071,000	881,700	189,300
1791	B	4,770,100	4,288,900	481,200	3,028,500	2,929,600	98,900	1,741,600	1,359,300	382,300
1792	A	635,000	457,900	177,100				635,000	457,900	177,100
Small contracts		413,400	349,500	63,900	32,100	25,900	6,200	381,300	323,600	57,700
		$14,854,600	$13,322,100	$1,532,500	$8,563,800	$7,988,100	$575,700	$6,290,800	$5,334,000	$956,800

Contract types
A—Fixed-price.
B—Cost-plus-fee.

Percentage Contractors, Inc.
Schedule 3
Contracts in Progress
December 31, 20X1

Contract		*Total contract*		*From inception to December 31, 20X1*						*At December 31, 20X1*		*For the year ended December 31, 20X1*		
Number	*Type*	*Revenues*	*Estimated gross profit (loss)*	*Revenues earned*	*Total costs incurred*	*Cost of revenues*	*Gross profit (loss)*	*Billed to date*	*Estimated cost to complete*	*Costs and estimated earnings in excess of billings*	*Billings in excess of costs and estimated earnings*	*Revenues earned*	*Cost of revenues*	*Gross profit (loss)*
1845	A	$6,750,200	$877,000	$5,890,500	$5,244,500	$5,143,900	$746,600	$875,400	$628,700	$15,100		$5,664,200	$4,984,500	$679,700
1847	B	1,471,800	127,100	1,250,400	1,139,800	1,139,800	110,600	1,195,800	204,900	54,600		962,800	899,000	63,800
1912	A	451,800	(130,100)	185,300	238,700	238,700	(53,400)	98,100	343,200	87,200		175,300	191,500	(16,200)
1937	B	11,125,000	847,900	7,337,900	7,045,500	6,721,100	616,800	7,483,600	3,231,600		$145,700	6,981,900	6,469,900	512,000
1945	A	3,650,100	497,000	2,395,200	2,061,300	2,061,300	333,900	2,491,500	1,091,800		96,300	2,395,200	2,061,300	333,900
Small contracts		51,300	8,400	49,800	41,700	41,700	8,100	49,800	1,200			39,000	30,700,	8,300
		$23,500,200	$2,227,300	$17,109,100	$15,771,500	$15,346,500	$1,762,600	$17,149,200	$5,501,400	$156,900	$242,000	$16,218,400	$14,636,900	$1,581,500

Contract types
A—Fixed-price.
B—Cost-plus-fee.

Appendix G

Sample Financial Statements Completed Contractors, Inc.*, †

The following sample financial statements of a construction contractor are included for illustrative purposes only and are not intended to establish reporting requirements. Furthermore, the dollar amounts shown are illustrative only and are not intended to indicate any customary relationship among accounts. The sample financial statements do not include all of the accounts and transactions that might be found in practice. The notes indicate the subject matter generally required to be disclosed, but they should be expanded, reduced, or modified to suit individual circumstances or materiality considerations. In addition to the illustrative notes that are presented, some of which are more or less peculiar to construction contractors, the notes to a construction contractor's financial statements should include information concerning subsequent events, pension plans, postretirement benefits other than pensions, postemployment benefits, stock options, lease commitments, extraordinary items, accounting changes, off-balance-sheet risks, and other matters that are not unique to construction contractors.

Completed Contractors, Inc.

Independent Auditor's Report

The Stockholders and Board of Directors

Completed Contractors, Inc.

We have audited the accompanying balance sheets of Completed Contractors, Inc. (the Company), as of December 31, 20X1 and 20X0, and the related statements of income and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan

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* Refer to the preface of this guide for important information about the applicability of the professional standards to audits of issuers and nonissuers (see definitions in the preface).

† The illustrative financial statements and footnote disclosures included in this guide have been updated to reflect the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC). However, FASB's notice to constituents suggests the use of plain English in financial statement footnotes to describe broad FASB ASC topic references. FASB suggests a reference similar to "as required by the Derivatives and Hedging Topic of the FASB Accounting Standards Codification." Entities might consider revising their financial statement references to reflect this plain English referencing, rather than using specific FASB ASC references. We have provided these detailed references as a resource for our users.

[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)." Refer to the PCAOB website at www.pcaobus.org for the full text of PCAOB Auditing Standards.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited*

(continued)

and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion*].[2] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of Completed Contractors, Inc., as of [at] December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

(*Firm Signature*)
Certified Public Accountants

City, State

February 18, 20X2

Additional Guidance When Performing Integrated Audits of Financial Statements and Internal Control Over Financial Reporting

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85–98 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), for direction about reporting on internal control over financial reporting. In addition, see paragraphs 86–88 of Auditing Standard No. 5), which includes an illustrative combined audit report.

(footnote continued)

Financial Statements (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB auditing standards. The ASB also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AuditingStandardsBoard/DownloadableDocuments/ASB%20Timetable.pdf for more information.

[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88). Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

If the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements in accordance with paragraph .08 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the X company's internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinions*].

When issuing separate reports on the company's financial statements and on internal control over financial reporting, the auditor also should add the following paragraph to the report on internal control over financial reporting in accordance with paragraph 88 of Auditing Standard No. 5:

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of X company and our report dated [*date of report*] expressed [*include nature of opinion*].

When performing an integrated audit of financial statements and internal control over financial reporting in accordance with the standards of the PCAOB, paragraph 89 of Auditing Standard No. 5 states that the auditor's report on the company's financial statements and on internal control over financial reporting should be dated the same date.

Completed Contractors, Inc.
Balance Sheets
December 31, 20X1 and 20X0

Assets	*20X1*	*20X0*	*Liabilities and Stockholders' Equity*	*20X1*	*20X0*
Current assets			Current liabilities		
Cash and cash equivalents	$242,700	$185,300	Current maturities, long-term debt (note 6)	$37,000	$30,600
Contracts receivable (notes 1 and 3)	893,900	723,600	Accounts payable	904,900	821,200
Costs in excess of billings on uncompleted contracts (note 4)	418,700	437,100	Accrued salaries and wages	138,300	155,100
Inventories, at lower of cost or realizable value on first-in, first-out basis (note 5)	463,600	491,300	Accrued and other liabilities	169,400	91,750
Prepaid expenses	89,900	53,900	Billings in excess of costs on uncompleted contracts (note 4)	34,500	43,700
Total current assets	2,108,800	1,891,200	Total current liabilities	1,284,100	1,142,350
Cash value of life insurance	35,800	32,900	Long-term debt, less current maturities (note 6)	245,000	241,000
			Total liabilities	1,529,100	1,383,350
Property and equipment, at cost			Stockholders' equity		
Building	110,000	110,000	Common stock—$10 par value, 50,000 authorized shares, 23,500 issued and outstanding shares	235,000	235,000
Equipment	178,000	163,000	Additional paid-in capital	65,000	65,000
Trucks and autos	220,000	200,000	Retained earnings	627,000	532,050
	508,000	473,000	Total stockholders' equity	927,000	832,050
Less: Accumulated depreciation	218,000	203,200	Total liabilities and stockholders' equity	$2,456,100	$2,215,400
	290,000	269,800			
Other assets	21,500	21,500			
Total assets	$2,456,100	$2,215,400			

The accompanying notes are an integral part of these financial statements.

Completed Contractors, Inc.
Statements of Income[3] and Retained Earnings
Years Ended December 31, 20X1 and 20X0

	20X1	*20X0*
Contract revenues	$9,487,000	$8,123,400
Costs and expenses		
Cost of contracts completed	8,458,500	7,392,300
General and administrative	848,300	643,100
Interest expense	26,500	23,000
	9,333,300	8,058,400
Net income	153,700	65,000
Basic and diluted earnings per share[4]	6.54	2.77
Retained earnings		
Balance, beginning of year	532,050	525,800
	685,750	590,800
Dividends paid ($2.50 per share)	58,750	58,750
Balance, end of year	$627,000	$532,050

The accompanying notes are an integral part of these financial statements.

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[3] FASB ASC 220, *Comprehensive Income*, establishes standards for the reporting and display of comprehensive income and its components. The guidance requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The guidance does not require a specific format for that financial statement but requires that an enterprise display an amount representing total comprehensive income for the period in that financial statement. FASB ASC 323-10-35-18 addresses the recording of an investor's share of the investee's other comprehensive income. FASB ASC 220 does not apply to an enterprise that has no items of other comprehensive income in any period presented.

[4] FASB ASC 260, *Earnings Per Share*, requires presentation of earnings per share by all entities that have issued common stock or potential common stock if those securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally. The guidance also requires presentation of earnings per share by an entity that has made a filing or is in the process of filing with a regulatory agency in preparation for the sale of those securities in a public market.

In August 2008, FASB issued a revised exposure draft of a proposed statement titled *Earnings per Share—an amendment of FASB Statement No. 128*. This proposed statement would amend the computational guidance in FASB Statement No. 128, *Earnings Per Share*, as codified in FASB ASC 260, for calculating the number of incremental shares included in diluted shares when applying the treasury stock method. Also, this proposed statement would eliminate the provisions of FASB Statement No. 128, as codified in FASB ASC 260, that allow an entity to rebut the presumption that contracts with the option of settling in either cash or stock will be settled in stock. In addition, this proposed statement would require that shares that will be issued upon conversion of a mandatorily convertible security be included in the weighted average number of ordinary shares outstanding used in computing basic earnings per share from the date when conversion becomes mandatory. Readers should be alert to the issuance of the final standard.

In December 2004, FASB issued Statement No. 123 (revised 2004), *Share-Based Payment*, primarily codified in FASB ASC 718, *Compensation—Stock Compensation*, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the fair value of the equity or liability instruments issued. Please refer to the FASB website at www.fasb.org for more information. Additionally, in March 2005, the Securities and Exchange Commission (SEC) released Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*. SAB No. 107 expresses views of the SEC staff regarding the application of FASB Statement No. 123(R), primarily codified in FASB ASC 718, by public companies, and provides interpretive guidance related to the interaction between FASB Statement No. 123(R), primarily codified in FASB ASC 718, and certain SEC rules and regulations.

Completed Contractors, Inc.
Statements of Cash Flows
Years Ended December 31, 20X1 and 20X0

	Years Ended December 31,	
	20X1	*20X0*
Cash flows from operating activities:		
Net income	$153,700	$65,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	54,800	50,300
Decrease in contracts receivable	(170,300)	(36,500)
Decrease in billings in excess of costs on uncompleted contracts	(9,200)	(16,300)
(Increase) decrease in costs in excess of billings on uncompleted contracts	18,400	(49,100)
Decrease (increase) in inventories	27,700	(3,400)
(Increase) decrease in prepaid expenses	(36,000)	16,500
Increase in cash value of life insurance	(2,900)	(2,685)
Increase in accounts payable	83,700	24,600
(Decrease) increase in accrued salaries and wages	(16,800)	24,300
(Decrease) increase in accrued and other liabilities	77,650	(39,400)
Net cash provided by operating activities	180,750	33,315
Cash flows from investing activities:		
Purchase of property and equipment	(75,000)	(53,500)
Net cash used in investing activities	(75,000)	(53,500)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	44,000	68,000
Principal payments on long-term debt	(33,600)	(15,500)
Cash dividends paid	(58,750)	(58,750)
Net cash used in financing activities	(48,350)	(6,250)
Net increase (decrease) in cash and cash equivalents	57,400	(26,435)
Cash and cash equivalents at beginning of year	185,300	211,735
Cash and cash equivalents at end of year	$242,700	$185,300

Supplementary data:

Cash equivalents include certificates of deposit with original maturities of one to three months—

Interest paid—20X1, $28,000; 20X0, $25,000

The accompanying notes are an integral part of these financial statements.

Completed Contractors, Inc.

Notes to Financial Statements

December 31, 20X1 and 20X0

1. Nature of Operations and Significant Accounting Policies[5]

Nature of operations. The Company is a heating and air conditioning contractor for residential and commercial properties serving the eastern region of New Hampshire. Work on new structures is performed primarily under fixed-price contracts. Work on existing structures is performed under fixed-price or time-and-material contracts.

Significant Accounting Policies

Use of estimates. The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Balance sheet classification. The Company includes in current assets and liabilities retainage amounts receivable and payable under construction contracts, which may extend beyond one year. A one-year time period is used as the basis for classifying all other current assets and liabilities.

Cash and cash equivalents. For purposes of reporting cash flows, the Company considers all highly liquid investments purchased with a maturity of three months or less as cash and cash equivalents in the accompanying balance sheets.

Contracts receivable. Contracts receivable from servicing heating and air conditioning systems for residential and commercial properties are based on contracted prices. Contracts receivable consist primarily of large groups of smaller-balance homogeneous accounts that are collectively evaluated for impairment; accordingly, the provisions of paragraphs 20–29 of FASB ASC 310-10-35 do not apply. Allowance for doubtful accounts is based upon a review of outstanding receivables, historical collection information, and existing economic conditions. Normal contracts receivable are due 30 days after the date of the invoice. Contract retentions are due 30 days after completion of the project and acceptance by the owner. Receivables past due more than 120 days are considered delinquent. Delinquent receivables are written off based on individual credit evaluation and specific circumstances of the customer.

Inventories. Inventories are stated at cost on the first-in, first-out basis using unit cost for furnace and air conditioning components and average cost for parts

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[5] On June 30, 2009, FASB issued FASB Statement No. 168, *The FASB* Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, which is codified at FASB ASC 105, *Generally Accepted Accounting Principles*. On the effective date of this statement, FASB ASC will become the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. At that time, FASB ASC will supersede all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. Once effective, all other nongrandfathered, non-SEC accounting literature not included in FASB ASC will become nonauthoritative. This statement is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

and supplies. The carrying value of furnace and air conditioning component units is reduced to realizable value when such values are less than cost.

Property and equipment. Property and equipment are stated at cost. Depreciation is computed primarily using the straight-line method over the estimated useful lives of the assets, which range from 5 to 39 years. Expenditures for repairs and maintenance are charged to expense as incurred.

For assets sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any related gain or loss is reflected in income for the period.

Impairment of long-lived assets. The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of these assets is determined by comparing the forecasted undiscounted net cash flows of the operation to which the assets relate to the carrying amount. If the operation is determined to be unable to recover the carrying amount of its assets, then assets are written down first, followed by other long-lived assets of the operation to fair value. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the assets. As of December 31, 20X1 and 20X0, there were no impairment losses recognized for long-lived assets.

Revenue and cost recognition. Revenues from fixed-price construction contracts are recognized on the completed-contract method. This method is used because the typical contract is completed in two months or less, and financial position and results of operations do not vary significantly from those which would result from use of the percentage-of-completion method. A contract is considered complete when all costs except insignificant items have been incurred, and the installation is operating according to specifications or has been accepted by the customer.

Revenues from time-and-material contracts are recognized currently as the work is performed.

Contract costs include all direct material and labor costs, and those indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs, and depreciation costs. General and administrative costs are charged to expense as incurred. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Claims are included in revenues when received.

Costs in excess of amounts billed are classified as current assets under costs in excess of billings on uncompleted contracts. Billings in excess of costs are classified under current liabilities as billings in excess of costs on uncompleted contracts. Contract retentions are included in contracts receivable.

Income taxes. The Company has elected subchapter S status for income tax purposes. Accordingly, a provision for income taxes has not been established.

Management has concluded that the Company is a pass-through entity for federal and certain states. Management has determined that there are no uncertain tax positions that would require recognition in the financial statements. If the Company were to incur an income tax liability in the future, interest on any income tax liability would be reported as interest expense and penalties on any income tax would be reported as income taxes. Management's conclusions regarding uncertain tax positions may be subject to review and adjustment

at a later date based on ongoing analysis of tax laws, regulations, and interpretations thereof as well as other factors. Generally, federal, state, and local authorities may examine the Company's tax returns for three years from the filing date and the current and prior three years remain subject to examination as of December 31, 20X1.

Basic earnings per common share. Basic earnings per common share were computed by dividing income available to common stockholders by the weighted average number of common share outstanding during the year. Diluted earnings per share are not presented because the Company has issued no dilutive potential common shares.

Subsequent events. The Company has performed a review of events subsequent to the balance sheet date through February 18, 20X2, the date the consolidated financial statements where available to be issued.

2. Fair Value of Financial Instruments[6,7,8,9,‡]

The carrying amounts of the Company's cash and cash equivalents and current maturities of long-term debt approximate their fair value. The fair value of the Company's long-term debt is estimated at $300,500 based on the future

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[6] In September 2006, FASB issued Statement No. 157, *Fair Value Measurements*, as codified in FASB ASC 820, *Fair Value Measurements and Disclosures*, which defines *fair value*, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements, FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this statement does not require any new fair value measurements, but the application of it will change current practice. Refer to chapter 2, "Accounting for Performance of Construction-Type Contracts," for additional discussion of this statement, including information pertaining to the effective date.

In February 2007, FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*, as codified in FASB ASC 825, *Financial Instruments*, that permits all entities, including not-for-profit organizations, to choose to measure eligible items at fair value at specified election dates. Notable eligible items include recognized financial assets and financial liabilities (except for those specifically prohibited), written loan commitments, and rights and obligations under a warranty that is not a financial instrument (because it requires or permits the insurer to provide goods or services rather than a cash payment) but whose terms permit the insurer to settle by paying a third party to provide those goods or services. Entities shall report assets and liabilities that are measured at fair value pursuant to the fair value option in this statement in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute. Refer to chapter 2 for additional discussion of this statement, including information pertaining to the effective date.

[7] FASB ASC 825-10-50-3 notes that for annual reporting periods, the disclosures about fair value of financial instruments prescribed in FASB ASC 825-10 are optional for entities that meet all of the following criteria:

a. The entity is a nonpublic entity.

b. The entity's total assets are less than $100 million on the date of the financial statements.

c. The entity has no instrument that, in whole or in part, is accounted for as a derivative instrument under FASB ASC 815, other than commitments related to the origination of mortgage loans to be held for sale, during the reporting period.

[8] AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. Please refer to chapter 9, "Planning the Audit, Assessing and Responding to Audit Risk, and Additional Auditing Considerations," for a discussion of AU section 328.

[9] In September 2009, FASB issued Accounting Standards Update (ASU) No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*. ASU No. 2009-12 provides guidance on using the net asset value per share provided by investees to estimate the fair value of an alternative investment. ASU No. 2009-12 provides amendments to FASB ASC 820 for the fair value measurement of investments in certain entities that calculate net asset value per share and requires disclosures by major category of investments about the attributes of those investments. Readers should consult ASU No. 2009-12 for further guidance.

ASU No. 2009-12 requires disclosures by major category of investment about the attributes of investments within the scope of ASU No. 2009-12. ASU No. 2009-12 is effective for interim and annual periods ending after December 15, 2009. Early application is permitted in financial statements for earlier interim and annual periods that have not been issued. If an entity early adopts the measurement amendments of ASU No. 2009-12, the entity is permitted to defer the adoption of the disclosure provisions of FASB ASC 820-10-50-6A until periods ending after December 15, 2009.

This guidance is located in FASB ASC 820-10-15, FASB ASC 820-10-35, FASB ASC 820-10-50, and FASB ASC 820-10-55 and is labeled as "Pending Content" due to the transition and effective date information discussed in FASB ASC 820-10-65-6. Refer to chapter 2 for additional discussion of this statement.

[‡] In January 2010, FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. ASU No. 2010-06 provides amendments to FASB ASC 820-10 that require new disclosures as follows:

a. Transfers in and out of levels 1 and 2. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.

(continued)

cash flows associated with each note discounted using the Company's current borrowing rate for similar debt.

3. Contracts Receivable

	December 31, 20X1	*December 31, 20X0*
Completed contracts, including retentions	$438,300	$408,600
Contracts in progress		
Current accounts	386,900	276,400
Retentions	78,700	46,600
	903,900	731,600
Less: Allowance for doubtful accounts	10,000	8,000
	$893,900	$723,600

Retentions include $10,300 in 20X1, which are expected to be collected after 12 months.

Contracts receivable include approximately $200,000 due under one contract.[10]

(footnote continued)

b. Activity in level 3 fair value measurements. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

ASU No. 2010-06 further provides amendments to FASB ASC 820-10 that clarify existing disclosures as follows:

a. Level of disaggregation. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.

b. Disclosures about inputs and valuation techniques. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and on recurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

ASU No. 2010-06 also includes conforming amendments to the guidance on employers' disclosures about postretirement benefit plan assets (FASB ASC 715-20). The conforming amendments to FASB ASC 715-20 change the terminology from *major categories of assets* to *classes of assets* and provide a cross reference to the guidance in FASB ASC 820-10 on how to determine appropriate classes to present fair value disclosures.

The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Refer to chapter 2 for additional discussion of this statement.

[10] FASB ASC 825 requires disclosure of concentrations of credit risks of all financial instruments. Concentrations can be geographical areas, types of contracts, owners or others. Additionally, the contractor should disclose, for each significant concentration, the policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the contractor's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments.

4. Costs and Billings on Uncompleted Contracts

	December 31, 20X1	*December 31, 20X0*
Costs incurred on uncompleted contracts	$2,140,400	$1,966,900
Billings on uncompleted contracts	1,756,200	1,573,500
	$384,200	$393,400
Included in accompanying balance sheets under the following captions:		
Costs in excess of billings on uncompleted contracts	$418,700	$437,100
Billings in excess of costs on uncompleted contracts	(34,500)	(43,700)
	$384,200	$393,400

5. Inventories

	December 31, 20X1	*December 31, 20X0*
Furnace and air conditioning components	$303,200	$308,700
Parts and supplies	160,400	182,600
	$463,600	$491,300

Furnace and air conditioning components include used items of $78,400 in 20X1 and $71,900 in 20X0 that are carried at the lower of cost or realizable value.

6. Long-Term Debt

	December 31, 20X1	*December 31, 20X0*
Notes payable, bank		
Notes due in quarterly installments of $2,500, plus interest at 8%	$140,000	$150,000
Notes due in monthly installments of $1,500, plus interest at prime plus $1^1/_2$%	87,000	58,000
Mortgage payable		
Due in quarterly payments of $3,500, including interest at 9%	55,000	63,600
	282,000	271,600
Less: Current maturities	37,000	30,600
	$245,000	$241,000

Principal payments on long-term debt are due as follows.

Year ending December 31,

20X2	$37,000
20X3	37,000
20X4	37,000
20X5	37,000
20X6	34,000
Later years	100,000

7. Contingencies

From time to time, the Company is involved in routine litigation that arises in the ordinary course of business. There are no pending significant legal proceedings to which the Company is a party for which management believes the ultimate outcome would have a material adverse effect on the Company's financial position.

8. Backlog

The estimated gross revenue on work to be performed on signed contracts was $4,691,000 at December 31, 20X1, and $3,617,400 at December 31, 20X0. In addition to the backlog of work to be performed, there was gross revenue to be reported in future periods under the completed-contract method used by the Company of $2,460,000 at December 31, 20X1, and $2,170,000 at December 31, 20X0.[11]

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[11] The presentation of backlog information, although encouraged, is not a required disclosure.

Appendix H

Information Sources

Further information on matters addressed in this guide is available through various publications and services listed in the table that follows. Many non-government and some government publications and services involve a charge or membership requirement.

Fax services allow users to follow voice cues and request that selected documents be sent by fax machine. Some fax services require the user to call from the handset of the fax machine, others allow the user to call from any phone. Most fax services offer an index document, which lists titles and other information describing available documents.

Recorded announcements allow users to listen to announcements about a variety of recent or scheduled actions or meetings.

All telephone numbers listed are voice lines, unless otherwise designated as fax (f) lines.

Information Sources

Organization	General Information	Fax/Phone Services	Internet Website	Recorded Announcements
American Institute of Certified Public Accountants	*Order Department* 220 Leigh Farm Road Durham, NC 27707-8110 Member Service Center (888) 777-7077 Technical Hotline (877) 242-7212	*General Information* (919) 402-4500	www.aicpa.org www.cpa2biz.com	
Financial Accounting Standards Board	*Order Department* 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700 (ext. 10)	*General Information* (203) 847-0700	www.fasb.org	*Action Alert Telephone Line* (800) 462-0393
United States Securities and Exchange Commission	*Publications Unit* 100 F Street NE Washington, DC 20549 (202) 551-4040 *SEC Public Reference Room* (202) 551-8090	*Information Line* (800) 732-6585	www.sec.gov	*Information Line* (800) 732-6585
United States Department of Commerce	1401 Constitution Avenue NW Washington, DC 20230	*General Information* (202) 482-2000 Bureau of Economic Analysis 1441 L Street NW Washington, DC 20230 (202) 606-9900	www.commerce.gov www.bea.gov	
Associated General Contractors of America	2300 Wilson Boulevard Suite 400 Arlington, VA 22201	*General Information* (703) 548-3118 (703) 548-3119 (f)	www.agc.org	
Professional Construction Estimators Association	P.O. Box 680336 Charlotte, NC 28216	*General Information* (704) 489-1494 (704) 489-1495 (f)	www.pcea.org	
Construction Financial Management Association	100 Village Blvd. Suite 200 Princeton, NJ 08540	*General Information* (609) 452-8000 (609) 452-0474 (f)	www.cfma.org	

Appendix I

International Financial Reporting Standards

> ***Note:*** The following content may include certain changes made since the original print version of the guide.

Introduction

The following information provides a brief overview of the ongoing globalization of accounting standards, International Financial Reporting Standards (IFRSs) as a body of accounting literature, the status of convergence with IFRSs in the United States, and the related issues that accounting professionals need to consider today.

Globalization of Accounting Standards

As the business world becomes more globally connected, regulators, investors, audit firms, and public and private companies of all sizes are expressing an increased interest in having common accounting standards among participants in capital markets and trading partners around the world. Proponents of convergence with, or adoption of, IFRSs for financial reporting in the United States believe that one set of financial reporting standards would improve the quality and comparability of investor information and promote fair, orderly, and efficient markets.

Many critics, however, believe that U.S. generally accepted accounting principles (GAAP) are the superior standards and question whether the use of IFRSs will result in more useful financial statements in the long term and whether the cost of implementing IFRSs will outweigh the benefits. Implementing IFRSs will require a staggering effort by management, auditors, and financial statement users, not to mention educators.

The increasing acceptance of IFRSs, both in the United States and around the world, means that now is the time to become knowledgeable about these changes. The discussion that follows explains the underpinnings of the international support for a common set of high quality global standards and many of the challenges and potential opportunities associated with such a fundamental shift in financial accounting and reporting.

The international standard setting process began several decades ago as an effort by industrialized nations to create standards that could be used by developing and smaller nations. However, as cross-border transactions and globalization increased, other nations began to take interest, and the global reach of IFRSs expanded. More than 100 nations and reporting jurisdictions permit or require IFRSs for domestic listed companies (and most have fully conformed to IFRSs as promulgated by the International Accounting Standards Board [IASB] and include a statement acknowledging such conformity in audit reports). Several countries are expected to transition to IFRSs by, or beginning

in, 2011, and many other countries have plans to converge (or eliminate significant differences between) their national standards and IFRSs.

For many years, the United States has been a strong leader in international efforts to develop globally accepted standards. Among other actions in support of IFRSs, the U.S. Securities and Exchange Commission (SEC) removed the requirement for foreign private issuers registered in the United States to reconcile their financial reports with U.S. GAAP if their accounts complied with IFRSs as issued by the IASB. In addition, the SEC continues to analyze and evaluate appropriate steps toward, and challenges related to, converging U.S. GAAP with IFRSs, as subsequently described.

In addition to the support received from certain U.S. based entities, financial and economic leaders from various organizations have announced their support for global accounting standards. Most notably, in 2009, the Group of Twenty Finance Ministers and Central Bank Governors (G20), a group from 20 of the world's systematically important industrialized and developing economies (with the 20th member being the European Union, collectively), called for standard setters to redouble their efforts to complete convergence in global accounting standards.

Acceptance of a single set of high quality accounting standards may present many significant opportunities, including the improvement in financial reporting to global investors, the facilitation of cross-border investments, and the integration of capital markets. Further, U.S. entities with international operations could realize significant cost savings from the use of a single set of financial reporting standards. For example, U.S. issuers raising capital outside the United States are required to comply with the domestic reporting standards of the foreign country and U.S. GAAP. As a result, additional costs arise from the duplication and translation of financial reporting information.

Many multinational companies support the use of common accounting standards to increase comparability of financial results among reporting entities from different countries. They believe common standards will help investors better understand the entities' business activities and financial position. Large public companies with subsidiaries in multiple jurisdictions would be able to use one accounting language company-wide and present their financial statements in the same language as their competitors. In addition, some believe that in a truly global economy, financial professionals, including CPAs, will be more mobile, and companies will more easily be able to respond to the human capital needs of their subsidiaries around the world.

Although certain cost reductions are expected, the initial cost of convergence with IFRSs is expected to be one of the largest obstacles for many entities, including accounting firms and educational institutions. Substantial internal costs for U.S. corporations in the areas of employee training, IT conversions, and general ledger software have been predicted. In addition, the time and effort required from various external functions, including the education of auditors, investors, lenders, and other financial statement users, will be significant factors for consideration.

Although the likelihood of acceptance of IFRSs may lack clarity for the time being, U.S. companies should consider preparing for the costly transition to new or converged standards, which likely will include higher costs in the areas of training and software compliance.

Who is the IASB?

The IASB is the independent standard setting body of the IFRS Foundation, formerly, the International Accounting Standards Committee Foundation. As a private sector organization, the IFRS Foundation has no authority to impose funding regimes on countries. However, a levy system and national contributions through regulatory and standard-setting authorities or stock exchanges have been introduced in a number of countries to fund the organization. Although the AICPA was a founding member of the International Accounting Standards Committee (IASC), the IASB's predecessor organization, it is not affiliated with the IASB.

The IASB, founded on April 1, 2001, in London, England, is responsible for developing IFRSs and promoting the use and application of these standards. In pursuit of this objective, the IASB cooperates with national accounting standard setters to achieve convergence in accounting standards around the world.

The structure includes the following primary groups: (*a*) the IFRS Foundation, an independent organization having two main bodies: the IFRS Foundation trustees and the IASB; (*b*) the IFRS Advisory Council; and (*c*) the IFRS Interpretations Committee, formerly the International Financial Reporting Interpretations Committee (IFRIC). The trustees appoint the IASB members, exercise oversight, and raise the funds needed, but the IASB itself has responsibility for establishing IFRSs.

The IASB board members are selected chiefly upon their professional competence and practical experience. The trustees are required to select members so that the IASB will comprise the best available combination of technical expertise and international business and market experience and to ensure that the IASB is not dominated by any particular geographical interest or constituency. The IASB has members from several different countries, including the United States. The members are responsible for the development and publication of IFRSs, including *International Financial Reporting Standard for Small- and Medium-sized Entities* (*IFRS for SMEs*), and for approving the interpretations of IFRSs as developed by the IFRS Interpretations Committee.

The IFRS Interpretations Committee, founded in March 2002, is the successor of the previous interpretations committee, the Standing Interpretations Committee (SIC), and is the interpretative body of the IASB. The role of the IFRS Interpretations Committee is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues in which interpretations are not sufficient.

IFRSs are developed through a formal system of due process and broad international consultation, similar to the development of U.S. GAAP.

Readers are encouraged to become involved in the standard-setting process by responding to open calls from the standard setting organizations.

What Are IFRSs?

The term *IFRSs* has both a narrow and broad meaning. Narrowly, IFRSs refers to the numbered series of pronouncements issued by the IASB, collectively called *standards*. More broadly, however, IFRSs refer to the entire body of authoritative IASB literature, including the following:

- Standards, whether labeled IFRSs or International Accounting Standards (IASs)[1]
- Interpretations, whether labeled IFRIC (the former name of the interpretive body) or SIC (the predecessor to IFRIC)[2]

The preface to the IFRS *2010 Bound Volume* states that IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-oriented entities, including commercial, industrial, and financial entities, regardless of legal form or organization. IFRSs are not designed to apply to not-for-profit entities or those in the public sector,[3] but these entities may find IFRSs appropriate in accounting for their activities.

The IASB's *Framework for the Preparation and Presentation of Financial Statements* (IASB Framework) establishes the concepts that underlie the preparation and presentation of financial statements for external users. The IFRS Foundation is guided by the IASB Framework in the development of future standards and in its review of existing standards. The IASB Framework is not an IFRS, and when there is a conflict between the IASB Framework and any IFRS, the standard will prevail. The IASB Framework is an overall statement of guidance for those interpreting financial statements, whereas IFRSs are issue and subject specific.

When an IFRS specifically applies to a transaction, other event, or condition, the accounting policy or policies applied to that item shall be determined by applying the IFRS and considering any relevant implementation guidance issued by the IASB for the IFRS.

Further, if an IFRS does not address a specific transaction, event, or condition explicitly, IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, states that management should use its judgment in developing and applying an accounting policy that results in information that is relevant and reliable. With respect to the reliability of financial statements, IAS 8 states that the financial statements (*a*) represent faithfully the financial position, financial performance, and cash flows of the entity; (*b*) reflect the economic substance of transactions, other events, and conditions; (*c*) are neutral; (*d*) are prudent; and (*e*) are complete in all material respects. When making this type of judgment, management should refer to, and consider the applicability of, the following in descending order:

- The requirements and guidance in IFRSs dealing with similar and related issues
- The definitions, recognition criteria, and measurement concepts for assets, liabilities, income, and expenses in the IASB Framework
- The most recent pronouncements of other standard setting bodies (for example, U.S. GAAP, other accounting literature, and accepted industry practices) to the extent that these do not conflict with IFRSs

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[1] See www.iasb.org for a current listing of International Financial Reporting Standards (IFRSs) and International Accounting Standards (IASs).

[2] See www.iasb.org for a current listing of International Financial Reporting Interpretations Committee and Standing Interpretations Committee interpretations.

[3] Generally speaking, *public* means government-owned entities, and *private* means non-government-owned entities.

IFRS for SMEs

IFRS for SMEs is a modification and simplification of full IFRSs aimed at meeting the needs of private company financial reporting users and easing the financial reporting burden on private companies through a cost-benefit approach. *IFRS for SMEs* is a self-contained, global accounting and financial reporting standard applicable to the general purpose financial statements of entities that, in many countries, are known as small- and medium-sized entities (SMEs). Full IFRSs and *IFRS for SMEs* are promulgated by the IASB.

SMEs are entities that publish general purpose financial statements for external users and do not have public accountability. An entity has public accountability under the IASB's definition if it files its financial statements with a securities commission or other regulatory organization or it holds assets in a fiduciary capacity (for example, banks, insurance companies, brokers and dealers in securities, pension funds, and mutual funds). It is not the IASB's intention to exclude entities that hold assets in a fiduciary capacity for reasons incidental to their primary business (for example, travel agents, schools, and utilities) from utilizing *IFRS for SMEs*.

The needs of users of SME financial statements often are different from the needs of users of public company financial statements and other entities that likely would use full IFRSs. Whereas full IFRSs were designed specifically to meet the needs of equity investors in the public capital markets, *IFRS for SMEs* was developed with the needs of a wide range of users in mind. Users of the financial statements of SMEs may be more focused on shorter-term cash flows, liquidity, balance sheet strength, interest coverage, and solvency issues. Full IFRSs may impose a burden on SME preparers in that full IFRSs contain topics and detailed implementation guidance that generally are not relevant to SMEs. This burden has been growing as IFRSs have become more detailed. As such, a significant need existed for an accounting and financial reporting standard for SMEs that would meet the needs of their financial statement users while balancing the costs and benefits from a preparer perspective.

Practically speaking, *IFRS for SMEs* is viewed as an accounting framework for entities that do not have the capacity or resources to use full IFRSs. In the United States, the term SME would encompass many private companies.

In May 2008, the AICPA Governing Council voted to recognize the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles and amended appendix A, "Council Resolution Designating Bodies to Promulgate Technical Standards," of Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01). This amendment gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. Accordingly, IFRSs are not considered to be an other comprehensive basis of accounting. Rather, they are a source of GAAP.

As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs*, has been removed. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs* and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.[4]

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[4] CPAs are encouraged to consult their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *International Financial Reporting Standard for Small- and Medium-sized Entities* within their individual state.

The AICPA has developed a resource that compares *IFRS for SMEs* with corresponding requirements of U.S. GAAP. This resource is available in a Wiki format, which allows AICPA members and others to contribute to its development. To learn more about the resource, view available sections, and contribute to its content, visit the Wiki at http://wiki.ifrs.com/.

The Financial Accounting Standards Board and IASB Convergence Efforts[5]

To address significant differences between IFRSs and U.S. GAAP, the Financial Accounting Standards Board (FASB) and the IASB agreed to a "Memorandum of Understanding" (MoU), which was originally issued in 2006 and subsequently updated. Readers are encouraged to monitor the FASB and IASB websites for additional developments regarding the convergence efforts, such as discussion papers, exposure drafts, and requests for comments.

Comparison of U.S. GAAP and IFRSs

One of the major differences between U.S. GAAP and IFRSs lies in the conceptual approach: U.S. GAAP is based on principles, with heavy use of rules to illustrate the principles; however, IFRSs are principles based, without heavy use of rules.

In general, a principles-based set of accounting standards, such as IFRSs, is broad in scope. The standards are concise, written in plain language, and provide for limited exceptions and bright lines. Principles-based standards typically require a higher level of professional judgment, which may facilitate an enhanced focus on the economic purpose of a company's transactions and how the transactions are reflected in its financial reporting.

A noticeable result of these differences is that IFRSs provide much less overall detail. In developing an IFRS, the IASB expects preparers to rely on core principles and limited application guidance with fewer prescriptive rules. In contrast, FASB often leans more toward providing extensive prescriptive guidance and detailed rules. The guidance provided in IFRSs regarding revenue recognition, for example, is significantly less extensive than U.S. GAAP. IFRSs also contain relatively little industry-specific guidance.

An inherent issue in a principles-based system is the potential for different interpretations of similar transactions across jurisdictions and entities, which may affect the relative comparability of financial reporting.

Because of long-standing convergence projects between the IASB and FASB, the extent of the specific differences between IFRSs and U.S. GAAP is decreasing. Yet, significant differences remain, which could result in significantly different reported results, depending on a company's industry and individual facts and circumstances. For example, some differences include the following:

- IFRSs do not permit last in, first out (LIFO) inventory accounting.
- IFRSs allow for the revaluation of assets in certain circumstances.

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[5] Because the convergence projects discussed are active and subject to change, updates will be posted periodically to www.journalofaccountancy.com. Readers also are encouraged to monitor the progress of these projects at the respective boards' websites: www.iasb.org and www.fasb.org.

- IFRSs use a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRSs have a different probability threshold and measurement objective for contingencies.
- IFRSs generally do not allow net presentation for derivatives.

U.S. GAAP also addresses some specific transactions not currently addressed in IFRSs, such as accounting for reorganizations, including quasi reorganizations; troubled debt restructuring; spin-offs; and reverse spin-offs. In addition, U.S. GAAP is designed to apply to all nongovernmental entities, including not-for-profit entities, and includes specific guidance for not-for-profit entities, development stage entities, limited liability entities, and personal financial statements.

The difference in the amount of industry-specific guidance also illustrates the different approaches. Currently, IFRSs include only several standards (for example, IAS 41, *Agriculture*)[6] that might be regarded as primarily industry-specific guidance. However, the scope of these standards includes all entities to which the scope of IFRSs applies. In contrast, U.S. GAAP has considerable guidance for entities within specific industries. For example, on liability recognition and measurement alone, U.S. GAAP contains specific guidance for entities in the following industries, which is not found in IFRSs:

- Health care
- Contractors and construction
- Contractors and the federal government
- Entertainment, with separate guidance for casinos, films, and music
- Financial services, with separate guidance for brokers and dealers and depository and lending, insurance, and investment companies

For nonmonetary transactions, U.S. GAAP provides specific guidance for the airline, software, and entertainment industries.

SEC Work Plan

The SEC continues to affirm its support for a single set of high-quality, globally accepted accounting standards and for the convergence of U.S. GAAP and IFRSs. In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to Release No. 33-8982, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The February 2010 release provides a confirmation of the SEC's continued support for convergence, highlights positive aspects of narrowing the differences between the two sets of standards, and outlines additional considerations required before adoption of a single standard is achieved.

The release also states that a more comprehensive work plan is necessary to lay out the work required to support a decision on the appropriate course to

[6] In addition to IAS 41, *Agriculture*, the other IFRSs that address issues specific to certain industries are IFRS 4, *Insurance Contracts*, and IFRS 6, *Exploration for and Evaluation of Mineral Resources*.

incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, timeframe, and methodology for any such transition. The SEC has indicated that it will carefully consider and deliberate whether a potential transition is in the best interest of U.S. investors and markets.

During 2011, assuming completion of the convergence projects and the SEC staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. The work plan is included as an appendix at the end of the SEC's release, which is located on the SEC's website at www.sec.gov.

AICPA

On February 24, 2010, president and CEO of the AICPA Barry Melancon issued a statement on the SEC's plan to work toward the incorporation of IFRSs in the U.S. financial reporting system. The statement noted that the AICPA supports the thoughtful and concrete steps the SEC is taking, as outlined in its plan, to prepare for the transition. The AICPA understands that it will need to fulfill a number of responsibilities to make the use of IFRSs in the United States a success. Ongoing efforts include the following:

- Continuing to educate AICPA members about IFRSs
- Working with accounting educators, textbook authors, and educational institutions to prepare future professionals to use IFRSs
- Making certain the voice of U.S. CPAs is heard internationally
- Incorporating questions about IFRSs into the Uniform CPA Exam

The AICPA believes that it is critical for the SEC to set a specific date for the use of IFRSs in the United States and encourages the SEC, as it completes this work plan in 2011, to ensure investor confidence is maintained and key milestones lead successfully to global standards in 2015. In moving forward, it is essential that all stakeholders—regulators, investors, auditors, educators, financial statement users, and preparers—have the knowledge and tools they need to successfully navigate any change in U.S. accounting rules. The AICPA is doing its part now to prepare these stakeholders for this fundamental shift in financial reporting.

Additional Resources

Website	*URL*
AICPA	www.aicpa.org
AICPA International Financial Reporting Standards Resources	www.ifrs.com
International Accounting Standards Board	www.iasb.org
Comparison Wiki of *International Financial Reporting Standard for Small- and Medium-sized Entities* and U.S. generally accepted accounting principles	http://wiki.ifrs.com
Financial Accounting Standards Board	www.fasb.org

Appendix J

Schedule of Changes Made to the Text From the Previous Edition

As of May 1, 2011

This schedule of changes identifies areas in the text and footnotes of this guide that have been changed from the previous edition. Entries in the table of this appendix reflect current numbering, lettering (including that in appendix names), and character designations that resulted from the renumbering or reordering that occurred in the updating of this guide.

Reference	*Change*
Preface	Updated.
Paragraphs 1.09–.10, 1.15, 1.22, 1.33–.34, 1.36, and 1.40–.41	Revised for clarification.
Former paragraph 1.22	Deleted.
Paragraphs 3.01, 3.08, and 3.25	Revised for clarification.
Footnote * in heading before paragraph 3.25 and footnote † in paragraph 3.25	Deleted.
Footnote 4 in paragraph 3.25	Added for clarification.
Footnote ‡ in paragraph 3.26	Deleted.
Paragraph 3.26	Revised to reflect the issuance of Accounting Standards Update (ASU) No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*.
Paragraph 3.27	Added to reflect the issuance of ASU No. 2009-17.
Footnote 5 in paragraph 3.27 and footnote 6 in paragraph 3.27	Revised to reflect the issuance of ASU No. 2009-17.
Paragraph 3.28	Added to reflect the issuance of ASU No. 2009-17.
Paragraphs 3.29–.30	Revised to reflect the issuance of ASU No. 2009-17.
Footnote || in paragraph 3.27	Deleted.

(continued)

Reference	*Change*
Paragraphs 3.31–.32	Added to reflect the issuance of ASU No. 2009-17.
Paragraph 3.37	Revised for clarification.
Paragraphs 4.03 and 4.10	Revised for clarification.
Footnote * in heading before paragraph 5.08	Deleted.
Paragraph 5.08	Revised for clarification.
Paragraphs 5.09–.12	Added.
Paragraphs 5.18 and 5.22	Revised for clarification.
Footnote † in paragraph 5.22	Deleted.
Footnote ‡ in heading before paragraph 5.25	Deleted.
Paragraph 5.25	Revised for clarification.
Footnote 1 in paragraph 5.27	Deleted.
Paragraphs 5.27 and 5.29	Revised for clarification.
Paragraph 5.36	Revised for clarification.
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Footnote † in paragraph 8.03	Revised to reflect the impact of Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Reference	*Change*
Footnote * in paragraph 9.03	Added to reflect the issuance of Public Company Accounting Oversight Board (PCAOB) Release No. 2010-004, *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* (AICPA, *PCAOB Standards and Related Rules*, Select PCAOB Releases).
Paragraphs 10.02 and 10.04	Revised for clarification.
Footnote † in paragraph 10.06	Added to reflect the issuance of PCAOB Release No. 2010-004.
Footnote † in paragraph 11.08	Added to reflect the release of PCAOB Release No. 2010-004.
Footnote † in paragraph 12.01	Added to reflect the issuance of PCAOB Release No. 2010-004.
Paragraph 12.08	Revised for clarification.
Paragraph 12.14	Revised for clarification.
Appendix B	Updated.
Appendix C	Updated.
Appendix E	Updated.
Appendix F	Updated.
Appendix G	Updated.
Appendix I	Updated.
Glossary	Updated.
Index	Updated.

Glossary

The following terms can be found in the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary:

contractor. A person or entity that enters into a contract to construct facilities, produce goods, or render services to the specifications of a buyer either as a general or prime contractor, as a subcontractor to a general contractor, or as a construction manager.

cost-type contracts. Contracts that provide for reimbursement of allowable or otherwise defined costs incurred plus a fee that represents profit. Cost-type contracts usually only require that the contractor use his best efforts to accomplish the scope of the work within some specified time and some stated dollar limitation.

expected losses. In the context of consolidations (chapter 3 of this guide and FASB ASC 810-10), a legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses. A VIE's expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.

expected losses and residual returns. In the context of consolidations (chapter 3 of this guide and FASB ASC 810-10), expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. The definitions of expected losses and expected residual returns specify which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity.

expected residual returns. In the context of consolidations (chapter 3 of this guide and FASB ASC 810-10), a variable interest entity's expected residual returns are the expected positive variability in the fair value of its net assets exclusive of variable interests.

expected variability. In the context of consolidations (chapter 3 of this guide and FASB ASC 810-10), expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the legal entity.

fixed-price contract. A contract in which the price is not subject to any adjustment by reason of the cost experience of the contractor or his or her performance under the contract.

joint venture. An entity owned and operated by a small group of businesses (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a joint venture frequently is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources

in developing production or other facilities. A joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a joint venture. The ownership of a joint venture seldom changes, and its equity interests usually are not traded publicly. A minority public ownership, however, does not preclude an entity from being a joint venture. As distinguished from a corporate joint venture, a joint venture is not limited to corporate entities.

percentage-of-completion method. A method of recognizing profit for time-sharing transactions under which the amount of revenue recognized (based on the sales value) at the time a sale is recognized is measured by the relationship of costs already incurred to the total of costs already incurred and future costs expected to be incurred.

profit center. The unit for the accumulation of revenues and costs and the measurement of income. For business entities engaged in the performance of contracts, the profit center for accounting purposes is usually a single contract. However, under some specified circumstances it may be a combination of two or more contracts, a segment of a contract, or of a group of combined contracts.

subcontractor claims. Those obligations of a contractor to a subcontractor that arise from the subcontractor's costs incurred through transactions that were related to a contract terminated but did not result in the transfer of billable materials or services to the contractor before termination.

time-and-material contract. Contracts that generally provide for payments to the contractor on the basis of direct labor hours at fixed hourly rates (that cover the cost of direct labor and indirect expenses and profit) and cost of materials or other specified costs.

unit-price contract. Contracts under which the contractor is paid a specified amount for every unit of work performed. A unit-price contract is essentially a fixed-price contract with the only variable being units of work performed. Variations in unit-price contracts include the same type of variations as fixed-price contracts. A unit-price contract is normally awarded on the basis of a total price that is the sum of the product of the specified units and unit prices. The method of determining total contract price may give rise to unbalanced unit prices because units to be delivered early in the contract may be assigned higher unit prices than those to be delivered as the work under the contract progresses.

The following is a list of additional terms that have been used in this guide:

back charges. Billings for 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. Owners bill back charges to general contractors, and general contractors bill back charges to subcontractors. Examples of back charges include charges for cleanup work and charges for a subcontractor's use of a general contractor's equipment.

backlog. The amount of revenue that a contractor expects to be realized from work to be performed on uncompleted contracts, including new contractual agreements on which work has not begun.

bid. A formal offer by a contractor, in accordance with specifications for a project, to do all or a phase of the work at a certain price in accordance with the terms and conditions stated in the offer.

bid bond. A bond issued by a surety on behalf of a contractor that provides assurance to the recipient of the contractor's bid that, if the bid is accepted, the contractor will execute a contract and provide a *performance bond*. Under the bond, the surety is obligated to pay the recipient of the bid the difference between the contractor's bid and the bid of the next lowest responsible bidder if the bid is accepted and the contractor fails to execute a contract or to provide a performance bond. (See the "Bonding and the Surety Underwriting Process" section in chapter 1.)

bid security. Funds or a *bid bond* submitted with a bid as a guarantee to the recipient of the bid that the contractor, if awarded the contract, will execute the contract in accordance with the bidding requirements and the contract documents.

bid shopping. A practice by which contractors, both before and after their bids are submitted, attempt to obtain prices from potential subcontractors and material suppliers that are lower than the contractors' original estimates on which their bids are based or, after a contract is awarded, seek to induce subcontractors to reduce the subcontract price included in the bid.

bidding requirements. The procedures and conditions for the submission of bids. The requirements are included in documents such as the notice to bidders, advertisement for bids, instructions to bidders, invitations to bid, and sample bid forms.

bonding capacity. The total dollar value of construction bonds that a surety will underwrite for a contractor, based on the surety's predetermination of the overall volume of work that the contractor can handle.

bonding company. A company authorized to issue *bid bonds*, *performance bonds*, *labor and materials bonds*, or other types of surety bonds.

bonus clause. A provision in a construction contract that provides for payments to the contractor in excess of the basic contract price as a reward for meeting or exceeding various contract stipulations, such as the contract completion date or the capacity, quality, or cost of the project.

broker. A party that obtains and accepts responsibility as a *general contractor* for the overall performance of a contract but enters into *subcontracts* with others for the performance of virtually all construction work required under the contract.

builders' risk insurance. Insurance coverage on a construction project during construction, including extended coverage that may be added for the contractor's protection or required by the contract for the customer's protection.

building codes. The regulations of governmental bodies specifying the construction standards that buildings in a jurisdiction must meet.

building permit. An official document issued by a governing body for the construction of a specified project in accordance with drawings and specifications approved by the governing body.

change orders. Modifications of an original contract that effectively change the provisions of the contract without adding new provisions. They include changes in specifications or design, method or manner of performance, facilities, equipment, materials, site, and period for completion of work. (See paragraphs 25–27 of FASB ASC 605-35-25.)

claims. Amounts in excess of the agreed contract price that a contractor seeks to collect from customers or others for customer-caused delays, errors in specifications and designs, unapproved change orders, or other causes of unanticipated costs. (See paragraphs 30–31 of FASB ASC 605-35-25.)

completed and accepted. A procedure relating to the time for closing jobs for tax purposes under the completed-contract method of accounting that allows closing a job when construction is physically completed and the customer has formally accepted the project as defined in the contract.

completion bond. A document providing assurance to the customer and the financial institution that the contractor will complete the work under the contract and that funds will be provided for the completion.

construction loan. Interim financing for the development and construction of real property.

construction management contractor. A party who enters into an agency contract with the owner of a construction project to supervise and coordinate the construction activity on the project, including negotiating contracts with others for all the construction work. (See the "Nature and Significance of the Industry" section in chapter 1.)

contract bond. An approved form of security executed by a contractor and a surety for the execution of the contract and all supplemental agreements, including the payment of all debts relating to the construction of the project.

contract cost breakdown. An itemized schedule prepared by a contractor after the receipt of a contract showing in detail the elements and phases of the project and the cost of each element and phase.

contract item (pay item). An element of work, specifically described in a contract, for which the contract provides either a unit or lump-sum price.

contract overrun (underrun). The amount by which the original contract price, as adjusted by *change orders*, differs from the total cost of a project at completion.

contract payment bond. The security furnished by the contractor to guarantee payment for labor and materials obtained in the performance of the contract. (See **payment (labor and materials) bond**.)

contract performance bond. The security furnished by the contractor to guarantee the completion of the work on a project in accordance with the terms of the contract. (See **performance bond**.)

critical path method. A network scheduling method that shows the sequences and interdependencies of activities. The critical path is the sequence of activities that shows the shortest time path for completion of the project.

draw. The amount of *progress billings* on a contract that is currently available to a contractor under a contract with a fixed payment schedule.

escalation clause. A contract provision that provides for adjustments of the price of specific items as conditions change (for example, a provision that requires wage rates to be determined on the basis of wage levels established in agreements with labor unions).

estimate (bid function). The amount of labor, materials, and other costs that a contractor anticipates for a project, as summarized in the contractor's bid proposal for the project.

estimated cost to complete. The anticipated additional cost of materials, labor, and other items required to complete a project at a scheduled time.

extras (customer's extras). Additional work, not included in the original plan, requested of a contractor that will be billed separately and will not alter the original contract amount. (See the "Contract Changes" section in chapter 1.)

final acceptance. The customer's acceptance of the project from the contractor on certification by an architect or engineer that the project is completed in accordance with contract requirements. The customer confirms final acceptance by making final payment under the contract unless the time for making the final payment is otherwise stipulated.

final inspection. The final review of the project by an architect or engineer before issuance of the final certificate for payment.

front-end loading. A procedure under which *progress billings* are accelerated in relation to costs incurred by assigning higher values to contract portions that will be completed in the early stages of a contract than to those portions that will be completed in the later stages so that cash receipts from the project during the early stages will be higher than they otherwise would be.

general contractor. A contractor who enters into a contract with the owner of a project for the construction of the project and who takes full responsibility for its completion, although the contractor may enter into *subcontracts* with others for the performance of specific parts or phases of the project. (See the "Nature and Significance of the Industry" section in chapter 1.)

incentives. (See **bonus clause** and **penalty clause**.)

letter agreement (letter of agreement). A letter stating the terms of an agreement between addressor and addressee, usually prepared for signature by the addressee as indication of acceptance of those terms as legally binding.

letter of intent. A letter signifying an intention to enter into a formal agreement and usually setting forth the general terms of such an agreement.

lien. An encumbrance that usually makes real or personal property the security for payment of a debt or discharge of an obligation.

liquidated damages. Construction contract clauses obligating the contractor to pay specified daily amounts to the project owner as compensation for damages suffered by the owner because of the contractor's failure to complete the work within a stated time.

loss contract. A contract on which the estimated cost to complete exceeds the contract price.

maintenance bond. A document given by the contractor to the owner guaranteeing to rectify defects in workmanship or materials for a specified time following completion of the project. A one-year bond is normally included in the performance bond.

mechanics lien. A lien on real property, created by statute in many areas, in favor of persons supplying labor or materials for a building or structure, for the value of labor or materials supplied by them. In some jurisdictions, a mechanics lien also exists for the value of professional services. Clear title to the property cannot be obtained until the claim for the labor, materials, or professional services is settled. Timely filing is essential to support the encumbrance, and prescribed filing dates vary by jurisdiction.

negotiated contract. A contract for construction developed through negotiation of plans, specifications, terms, and conditions without competitive bidding.

payment (labor and materials) bond. A bond executed by a contractor to protect suppliers of labor, materials, and supplies to a construction project.

penalty clause. A provision in a construction contract that provides for a reduction in the amount otherwise payable under a contract to a contractor as a penalty for failure to meet targets or schedules specified in the contract or for failure of the project to meet contract specifications.

performance bond. A bond issued by a surety and executed by a contractor to provide protection against the contractor's failure to perform a contract in accordance with its terms. (See the "Bonding and the Surety Underwriting Process" section in chapter 1.)

prequalification. The written approval of an agency seeking bids on a project that authorizes a contractor to submit a bid on the project in circumstances in which bidders are required to meet certain standards.

prime contract. A contract between an owner of a project and a contractor for the completion of all or a portion of a project under which the contractor takes full responsibility for the completion of the work.

prime contractor. A contractor who enters into a contract with the owner of the project for the completion of all or a portion of the project and who takes full responsibility for its completion. (See **general contractor**.)

progress (advance) billings. Amounts billed in accordance with the provisions of a contract on the basis of progress to date under the contract.

punch list. A list made near the completion of work indicating items to be furnished or work to be performed by the contractor or subcontractor in order to complete the work as specified in the contract.

quantity takeoffs. An itemized list of the quantities of materials and labor required for a project, with each item priced and extended, which is used in preparing a bid on the project.

retentions. Amounts withheld from progress billings until final and satisfactory project completion.

specifications (specs). A written description of the materials and workmanship required on a project (as shown by related working drawings),

including standard and special provisions related to the quantities and qualities of materials to be furnished under the contract.

stop order. A formal notification to a contractor to discontinue some or all work on a project for reasons such as safety violations, defective materials or workmanship, or cancellation of the contract.

subcontract. A contract between the *prime contractor* and another contractor or supplier to perform specified work or to supply specified materials in accordance with plans and specifications for the project.

subcontractor bond. A bond executed by a subcontractor and given to the *prime contractor* to assure the subcontractor's performance on the *subcontract*, including the payment for all labor and materials required for the *subcontract*.

substantial completion. The point at which the major work on a contract is completed and only insignificant costs and potential risks remain. Revenue from a contract is recognized under the completed-contract method when the contract is substantially completed. (See paragraphs 96–97 of FASB ASC 605-35-25.)

surety. (See **bonding company**.)

turnkey project. A project for which a contractor undertakes under contract to deliver a fully operational and tested facility before being entitled to payment.

unbalanced bid. A bid proposal under which the contract price is allocated to phases or items in the contract on a basis other than that of cost plus overhead and profit for each bid item or phase. A common practice is to *front-end load* a bid proposal to obtain working capital to finance the project. Another form of unbalanced bid on unit-price contracts assigns higher profits to types of work for which the quantities are most likely to be increased during the performance of the contract.

waiver of lien. An instrument by which the holder of a *mechanics or materials* lien against property formally relinquishes that right.

warranty (maintenance) period. A specified period, which is normally specified in the contract, after the completion and acceptance of a project, during which a contractor is required to provide maintenance construction, and for which the contractor is required to post a *maintenance bond*.

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