PP017 – Reporting Revenue

Introduction/History

Surety companies often encounter a serious problem in the reporting of revenue on a contractor's financial statements. Imprecise reporting standards have led to serious discrepancies in revenue recognition and in many cases; the contractor's profitability is materially misstated.

SAC Position

It is the position of the Surety Association of Canada that revenue should be recognized using the "percentage of completion" method as determined by comparing cost-to-date to estimated total cost of the project.

Surety companies have long been aware of a serious problem in the reporting of revenue for construction contractors in Canada. The Association believes that the problem can be traced to directions provided in the C.I.C.A. Handbook which are sufficiently vague as to allow a wide variety of interpretations and may lead to the provision of financial information which is misleading.

We refer in particular to Section 3400 which deals with the issue of revenue recognition. Section 3400 offers the following definitions for the Percentage of Completion Method:

> *A method of accounting that recognizes revenue proportionately with the degree of completion of goods or services under contract.*

With respect to construction contracts and other long-term obligations, Paragraph 3400.08 attempts to place a finer point on the definition by stating:

> *In the case of rendering services and long-term contracts, performance should be determined by using either the percentage of completion method or the completed contract method, whichever relates the revenue to the work accomplished. Such performance should be regarded as having been achieved when reasonable assurance exists regarding the measurement of the consideration that will be derived from rendering the service or performing the long-term contract.*

While this seems appropriate enough as a general guideline, its value as a working directive to accounting practitioners in the construction industry is questionable. Specifically, we believe that the accounting standards do not provide enough guidance as to the way in which the percentage of completion method should be applied, and that using billings-to date as a measure of completion may be inappropriate for revenue recognition purposes. Industry experience indicates that contractors and their accountants frequently focus on billings-to date to determine to determine a project's progress. This approach usually has the effect of front ending profit recognition and can materially distort the true profit based on a proper matching of costs and revenue.

This is not an issue of simple non-compliance. In discussing the issue with Chartered Accountants who offer such audit opinions it appears that they truly believe that they are in full compliance with Section 3400 as written. Reviewing the language used in paragraph 3400.08 this assertion would seem to have merit. Indeed a reasonable individual can conclude that "reasonable assurance" as to performance exists when a customer or their representative (architect or consulting engineer) approves the contractor's invoice for payment, notwithstanding that such an approach can seriously distort a contractor's financial picture.

To illustrate the nature of the dilemma, consider XYZ Construction Ltd. which at its fiscal year end had one job in progress as shown:

XYZ Construction Ltd.						
		Original Estimate		To Date		
Job	Contract Price	Cost	Profit	Billings	Costs	Remaining Costs to Complete
1	$1,600,000	$1,400,000	$200,000	$1,000,000	$750,000	$750,000

Employing the **"Cost-to-Cost Percentage of Completion Method"**, the job is 50% complete at year-end and has generated revenue of $800,000 with a gross profit of $50,000. The balance sheet will include a $200,000 allowance for "Billings in Excess of Costs and Estimated Earnings" shown as a current liability.

By contrast, the **"Billings-to-Contract Price Percentage of Completion Method"** will yield a different and a slightly distorted revenue picture. Using this method, the job is 62.5% complete at year-end and has generated revenue of $1 million with an earned gross profit of $62,500; $12,500 more than would be earned under the cost-to-cost method. Using this method, $188,000 would appear as a current liability on the balance sheet to reflect the amount "over billed" to the project owner. If a project is over-billed, this method of revenue recognition will result in profits being earned quicker than the cost-to-cost method. Alternatively, if a project is under-billed profits will be earned slower than the cost-to-cost method. In the end, both methods of revenue recognition will converge to an identical earned profit amount once the project has been completed.

An even more distorted picture emerges when the **"Pure Progress Billings Method"** is applied. Under this method, revenue is recognized at the moment the invoice is submitted to the project owner with no regard to the true extent of completion of the physical work nor any balance sheet allowances for overbilling. Revenue is now $1.0 million with $250,000 in gross profit, despite the fact that as the job proceeds to completion, the lion's share of these "profits" will disappear to arrive at a final gross profit of $100,000.

Field experience suggests that the practice of using billings-to-date as a measure of project completion is widespread. During the course of earlier discussions with C.I.C.A., the Surety Association of Canada contacted underwriters from the largest bonding firms in the industry. These underwriters were asked to choose 10 files at random with statements purportedly prepared on the percentage of completion basis. On average less than 50% were actually prepared using the **Cost to Cost Percentage of Completion Method**. Most were prepared under the **Billings to Contract Price Percentage of Completion Method** and some even using the **Pure Progress Billings Method**.

While many accounting firms have their own more detailed guidance and many make use of other authoritative literature (e.g. Skinner - Accounting Standards in Evolution and The A.I.C.P.A. Auditing and Accounting Guide for Construction Contractors in particular), many it seems do not. To its credit, C.I.C.A. has recognized the seriousness of this dilemma. In January 1997, The Emerging Issues Committee published EIC-78 Construction Contractors – Revenue Recognition When the Percentage Completion Method is Applicable. This abstract articulated the problem in more detail and directed practitioners' attention to the authoritative sources mentioned above. Despite this laudable effort however, surety personnel continue to observe a preponderance of financial statements which purport to be prepared under the percentage of completion method but are in fact using some variation of a billings/accrual basis of revenue recognition.

The Surety Association of Canada urges contractors and accounting professionals to adopt the revenue recognition method that most accurately reflects the measure of completion of projects in progress. We suggest that in the majority of cases this will be the Cost to Cost Percentage of Completion Method. We believe as well that revenue recognition methods that distort the true profit picture such as the Pure Progress Billings Method should be avoided.

Summary

Finally, the Surety Association of Canada believes that the establishment and enforcement of a more thorough approach to recognition of construction revenue is in the interest of all parties. In that regard, the following suggestions are offered:

- Accountants provide a clearly articulated and detailed description of the revenue recognition policy in the notes to the financial statement.
- A schedule should be included with the financial statement which details the status of each job in progress at the statement date. Such schedule should include:
    - Revised Contract Price including any and all approved change orders.
    - The original estimate of job cost and gross profit.
    - Amount invoiced to the client.
    - Total job cost to date.
    - Estimated cost to complete.
- A second schedule which details the status of jobs completed during the fiscal period. This schedule should include:
    - Final contract price
    - Final job cost and gross profit
    - Job costs incurred and gross profit earned during prior fiscal period(s)
    - Job costs incurred and gross profit earned during the current fiscal period
- Appropriate balance sheet treatment of over and under billings where applicable. The amounts shown on the balance sheet should be easily identifiable from an analysis of the two schedules discussed above.

To operate effectively in today's competitive marketplace, a contractor needs a healthy relationship with their surety, bank and other creditors. Detailed and thorough financial information with appropriate treatment of revenue recognition will enhance a surety's confidence in a contractor's operation and will go a long way toward helping the firm meet its business objectives.

Glossary of Terms

Obligee

An individual or organization in whose favour an obligation is created and to whom a bond is given.

Principal

The individual or organization that bears the primary responsibility for fulfilling the obligation under the written contract referenced in the bond and that has the duty to perform for the Obligee's benefit.

Surety

The party to a surety bond who answers to the Obligee for the Principal's default or failure to perform as required by the underlying contract, permit or law.

This paper is intended to serve as a general guideline to assist members and other readers in responding to the issues discussed. Nothing contained herein should be construed as legal advice and readers are cautioned to consult with legal counsel for such advice.

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