

Accounting Methods – 4 Methods

WHEN to Recognize (or report) Profit and Loss on Your Income Statement

1: Cash 2: Accrual 3: Completed Contract 4: Percentage of Completion

1 - CASH METHOD:

Report Revenues when they are received

Report Costs when they are paid

Does NOT matter whether the Revenues are Earned OR

What other Costs are incurred

Cash Method just records Deposits and Checks

2 - ACCRUAL METHOD:

Report Revenues When They are EARNED (usually when billed)

Report Costs When They are INCURRED

Does NOT matter whether Cash Transaction has taken place

Accrual Method records Monies Due From Customers to Company

AND Monies Due From Company to Suppliers and Contractors

Accrual Method Provides More Timely and Accurate Financials but for most home builders may not be giving a true picture of the company's financial position. Builders often prepare "Front End Loaded" Billings to customers that unrelated to costs incurred.

Accounting Methods - continued

3 – Completed Contract:

Revenue and Expenses are NOT recorded on Income Statement until the contract is complete.

During Progress of Job:

Customer Payments are Recorded as Liabilities

Construction Costs are recorded as a “Work In Progress” Asset

Completed Contract Method may be good for tax purposes because builder can defer paying taxes on a project until it is complete, but does not give tools to manage the business.

4 – Percentage of Completion:

Revenues are recorded on the Income Statement based on a periodic measure of progress (when they are actually Earned).

(as opposed to when they are received or billed)

Construction Costs are recorded as they are incurred.

Percentage of Completion is the most desirable for projects that span over several months because it more accurately matches costs with revenues (or net profit and loss) for a given period.

Compare the Methods...

Contract: \$500,000 Estimated Costs: \$400,000 Est. Profit: \$100,000

First Progress Billing Prepared for \$50,000 (not received yet)

Cash Paid for Plans, Permits, Fees, etc. of \$5,000

Invoice Received from Foundation Company for \$15,000

| | Cash Method | Basic Accrual | Completed Contract | Percentage of Completion |
|---------------------|-------------------------|--------------------------------|---------------------------|---------------------------------|
| Revenue | | \$50,000 Amt Billed | \$0 | *\$25,000 Calculated |
| Costs | \$5,000 Paid | \$20,000 Incurred | \$0 | \$20,000 Incurred |
| Gross Profit | -\$5,000 | \$30,000 | \$0 | \$5,000 |

*Calculate Percentage of Completion Revenue:

1: Calculate Percent Complete: $\$20,000 \text{ Costs} / \$400,000 \text{ Est. Costs} = 5\% \text{ Complete}$

2: Multiply Percent Complete times Contract: $\$500,000 \times 5\% = \$25,000$

Percentage of Completion BEST reflects the company's Revenues, Costs, and Gross profit for the period.

Cash method will make you think you are losing money.

Accrual Method makes owner think company is really prospering!

Completed Contract shows nothing until job is done. Weird spread for company owner over 12 months... 4 months lose money, 5th month make big profit!

To quote Steve Maltzman, consultant to Builder 20 clubs... The Percentage of Completion method gives best picture, but is STILL ONLY an ESTIMATE. It requires that the contract and total costs are properly estimated, AND that the job cost system is accurate, up-to-date, and is easily compared to the cost estimate. The builder MUST HAVE the ability to easily produce the information necessary to make a reasonable estimate as to the progress of the job.

Percentage of Completion Entry Method

| | ASSETS | | | LIABILITIES | | | Equity | Income Stmt | |
|--------------------------|---------------|--------------------|------------------|----------------|-------------------|---------------------|----------------|----------------|-------------------------|
| | Cash | WIP - Constr Costs | Costs Recognized | Accts Payable | Contract Deposits | Revenues Recognized | Owner Equity | Revenues | Costs of Sales/Overhead |
| Owner Invest | 30,000 | | | | | | -30,000 | | |
| Customer Pmt Received | 50,000 | | | | -50,000 | | | | |
| Pay Job Costs | -5,000 | 5,000 | | | | | | | |
| Pay Overhead Expenses | -4,000 | | | | | | | | 4,000 |
| Foundation Bill | | 15,000 | | -15,000 | | | | | |
| TOTALS | 71,000 | 20,000 | | -15,000 | -50,000 | | -30,000 | | 4,000 |
| At End Of Period: | | | | | | | | | |
| Recognize Costs | | | -20,000 | | | | | | 20,000 |
| % Complete Revenue | | | | | | 25,000 | | -25,000 | |
| TOTALS | 71,000 | 20,000 | -20,000 | -15,000 | -50,000 | 25,000 | -30,000 | -25,000 | 24,000 |

Percentage of Completion Financial Statements – Using “Contra” Accounts

Contra Accounts - Purpose: To Keep Track of Totals In Original Accounts

A “Contra” Account REDUCES the normal total for a Group of Accounts. It’s “contra”dictive!

| BALANCE SHEET | | INCOME STATEMENT | |
|---|-----------------|---------------------------|---------|
| As Of End of Period | | For the Period | |
| ASSETS | | | |
| Cash | 71,000 | Sales | 25,000 |
| WIP Construction Costs | 20,000 | Cost Of Sales | 20,000 |
| Costs Recognized | -20,000 | Gross Profit | \$5,000 |
| Totals Assets | \$71,000 | | |
| LIABILITIES | | Operating Expenses | |
| Accounts Payable | 15,000 | List of Expenses | 4,000 |
| Contract Deposits | 50,000 | Total Expenses | \$4,000 |
| Revenues Recognized | -25,000 | Net Income (or Loss) | \$1,000 |
| Total Liabilities | \$40,000 | | |
| OWNER'S EQUITY | | | |
| Investment | 30,000 | | |
| Current Period Earnings | 1,000 | | |
| Total Owner's Equity | \$31,000 | | |
| Total Liabilities & Owner's Equity | \$71,000 | | |

End of the month: \$50,000 Contract Deposit Less \$25,000 EARNED represents a Liability due to the Customer of \$25,000 for amount that has not been earned yet! If the job failed right now, you would owe the Customer \$25,000.

Next Month: Do the Same Thing!

“Costs Recognized” and “Revenues Recognized” are CONTRA accounts.

Percentage of Completion (ongoing entries)

If you don't have an accounting software that will calculate Percentage of Completion for you, set up contra accounts in your accounting software to gather totals. Then create an Excel spreadsheet with formulas that will do the calculation on your totals from the accounts.

| | | |
|---|-----------|-----------|
| WIP Construction Costs End of Current Period | 60,000 | A |
| Total in "Costs Recognized" at End of Previous Period | -20,000 | B |
| Costs to Recognize End of Current Period | \$40,000 | C (A-B) |
| Divided by Estimated Construction Costs | / 400,000 | D |
| Revenue Earned Percent | = 10% | E (C/D) |
| Times the Total Contract Price | X 500,000 | F |
| Revenue to Recognize End of Current Period | \$50,000 | G (F X E) |

"Journal Entries" – Entries on the Accounting Books

| | | |
|---|---------|-------------------------|
| Costs Recognized (reduces Assets) | -40,000 | Credit (Contra Account) |
| Cost of Sales (reduces Income) | 40,000 | Debit |
| Revenues Recognized (reduces Liabilities) | 50,000 | Debit (Contra Account) |
| Revenues (increases Income) | -50,000 | Credit |