

Recognizing Profit on a Job
Methods of Accounting.....Decide what YOU want to know!
and THEN discuss with your accountant advisor.

"Recognizing Profit" - Profit from a job usually appears on an Income (Profit and Loss) Statement when revenues received are posted to a "Sales" account, and when costs of the job are posted to a "Cost of Sales" account. Deciding WHEN revenues and costs are actually posted to these accounts depends on your method of accounting.

NOTE: Please do not confuse "Recognizing Profit" on your books with Transferring a profit amount from one checking account to another within your company.

ALSO: Remember that this is YOUR set of books, NOT your customer's. See information at the end of this report about including profit in your job's budgeted costs, or NOT.

CHS does not "control" when profit is recognized. Profit recognition depends on the accounting method you elect to use in your company. There are tools available in CHS to help you recognize profit based on your method of accounting.

FINANCIAL STATEMENT DEFINITIONS: A "Balance Sheet" displays your Assets (things the company owns), your Liabilities (things the company owes to outsiders), and your Equity (things the company "owes" to the company owners). An Income Statement generally displays Sales less Cost of Sales less Overhead Expenses totaling to a Net Profit or Loss for the company. The total Net Profit or Loss from the Income Statement will appear in the Equity section of the Balance Sheet which increases or decreases the amount "due" to the company owners (depending on profit or loss).

METHODS for Recognizing Profit from Jobs on the Income Statement:

"Cash" Method

In the construction industry, this method is usually the LEAST favored. Using the "Cash" method of profit recognition means that all monies received are posted directly to Sales as soon as they are received and all costs are posted to Cost of Sales as soon as they are paid. Most advisors state that this can cause an Income Statement to be misleading. For example, if you receive a \$20,000 down payment during a month and no costs for the job have been incurred or posted, your Income Statement for the month would reflect a \$20,000 "profit" for the month. OR, if you pay \$5,000 in "up front" costs for a job before any money is received, your Income Statement for the month would reflect a \$5,000 "loss" for the month. Advisors argue that neither one of these results gives a true picture of the profitability of the company. If you are in the construction industry, you will probably understand right away why this is true.

If you elect to use the "Cash" method of accounting in CHS, simply post all deposits received for a job to Sales (GL Accounts 3000-3100 series on NAHB chart), and post all costs to Cost of Sales (GL Accounts 3500-3600 series on NAHB chart). You will NOT need to use the screen to "Close the Job..." in this case. AGAIN, this method is not usually advised to reflect a true picture of Profitability for your company.

Continue to Next Page

METHODS for Recognizing Profit from Jobs on the Income Statement - continued

"Completed Contract" Method

Using the "Completed Contract" method means that the profit from a job is NOT recognized until the job is complete and the contract closing has occurred. This means that all revenues (or monies) received AND all costs incurred (posted) will be posted to accounts on your Balance Sheet (NOT on your Income Statement) while the job is "in progress".

If you elect to use the Completed Contract method, Monies received are posted to Construction "Liability" accounts like Contract Deposits, Construction Loans Payable, Change Order Deposits, etc. (GL Accounts 2000-2099 on NAHB Chart of Accounts). The term "liability" indicates that your company owes this money to someone (like the customer if the job is not completed, OR the lender until the job is completed). Job Costs incurred (or posted) are posted to a "Work In Progress" account (like #1430-Direct Construction Costs on the NAHB chart of accounts).

Using the Completed Contract method, when a job "closes", the revenue totals will be moved from the Construction Liability accounts on your Balance Sheet TO the Sales account on your Income Statement. The job cost totals will be moved from the Work In Progress account (Direct Construction Costs) on your Balance Sheet TO the Cost of Sales account on your Income Statement. (Sales Less Cost of Sales = Gross Profit on Jobs; Gross Profit less Overhead Expenses = Net Income or Loss). In this case the Gross Profit will not appear on your Income Statement UNTIL you have "closed" the job.

There is a screen available to help create the "journal entry" that is necessary to "Close the Job to Sales and Cost of Sales" using the Completed Contract method. This screen should be used AFTER the closing deposit for the job is received from the Title Company or Customer, AND posted on the Add/Edit Deposits screen.

NOTE: Advisors will argue that the Completed Contract method of accounting may not give a true picture of the profitability of your company. When all the profit is recognized AFTER a job has closed, there is not profit being recognized as the job is in progress. In the month that the job closes, the entire profit is recognized, and during the preceding months, NO profit is recognized from the job. This does not give you a true picture of profitability because it does not show that you are "earning" profit as the job progresses. If you'd like to recognize the profit that your company is "Earning" as you go, see the Percentage of Completion methods described below.

METHODS for Recognizing Profit from Jobs on the Income Statement - continued

"Percentage of Completion" Method

This method can seem a little overwhelming, but CHS will handle most of it for you!

The "Percentage of Completion" method recognizes gross profit (revenues less costs) throughout the life of each contract based upon a periodic measurement of progress. This method is preferred by many consultants because it more accurately matches costs with revenues, and therefore profit, for a given period.

If you use the "Percentage of Completion" method, you will periodically (usually at the end of each month) calculate how much Revenue you have earned based upon the total of costs that have been "incurred" for the job (whether paid or not). This method **REQUIRES** that the Contract Price has been properly determined, that a budget for estimating the job's costs has been prepared, **AND** that the job costs have been posted as they are incurred.

To use the "Percentage of Completion" method, you must determine how much Revenue has been **EARNED** on the job. Revenue **EARNED** will probably **NOT** be the same as Revenues Received. Revenue Earned is calculated by first figuring out the percentage that the job is complete. The "Percent Complete" is calculated by dividing the Total Costs To Date by the Estimated Costs for the job. The resulting Percent Complete is applied to the Contract Price to determine how much Revenue has been Earned. Ex: Contract Price is \$500,000, and Costs are estimated to be \$400,000. If \$100,000 of Costs have been posted, divide \$100,000 by \$400,000 to determine that the job is 25% complete. Multiply the Contract Price of \$500,000 times 25% to determine that the Revenue Earned is \$125,000.

Once the amount of Revenue Earned has been calculated, Journal Entries (or entries to your books) must be prepared to recognize the progressive Revenue Earned and Costs of Sales (or costs incurred) on your Income Statement. CHS provides a very handy screen that will calculate the Revenue Earned for all jobs in progress, **AND** that will prepare the associated Journal Entries to recognize the progressive profit on your Income Statements. Search for Percentage of Completion in the Index.

NOTE: If you use the Percentage of Completion method, the **FINAL** closing entry for the job can be prepared using the Job Closing entry screen to clear all accounts to Sales and Cost of Sales (After posting the closing Deposit).