



New Approaches to Revenue Recognition and Auditing Independence

BY DENICE D. HERTLEIN

R *evenue recognition and the independence of external auditors are two hot topics in the accounting industry. What does this mean for construction financial managers from an outside auditor's point of view?*

Revenue Recognition

Companies that are public, have the prospect of going public, or have interests in ventures with public entities, are facing the pressure of meeting earnings expectations and “compounded annual growth rates.” How and when to recognize revenue has come front and center, so outside auditors will be looking at revenue recognition with a renewed sense of urgency and skepticism. And, while the spotlight currently shines on the public sector, the entire industry will probably be affected (in much the same way the “materiality” issues affected both public and private entities).

To date, the focus is on two areas of risk to the public users of financial statements:

- The recognition of revenue in advance of when it was actually earned; and
- The construction of revenue using such smoothing techniques as accruals, deferrals, and allowances.

Attention is also being paid to using advance recognition of expenses or contingencies in order to “cleanse” financial statements, such as projecting a one-time expense not to be considered in the continuing net income. A recently publicized example is the accrual of post-retirement benefits for health insurance at significantly higher-than-expected rates; later, these accruals are adjusted down to more realistic values, creating income in the process.

Too Much of a Good Thing?

Our robust economy has been kind to the construction industry, providing many opportunities for growth and profits, while

simultaneously posing many challenges, including a scarcity of resources. The abundance of work has stretched field crews to their limits, while support staffs are being asked to handle a significantly higher volume of transactions without additional help.

In addition, it's difficult for financial managers to get accurate information from their owners and project managers, whose sense of caution tends to wane as the good times continue. From their point of view, the chances of failure are minimized; current obstacles or future small “blips” on the radar screen are expected to be corrected by upcoming profitable jobs.

Planning for Profitability

However, now is precisely the time for construction financial managers to re-examine how revenue is recognized on contracts, to evaluate the systems in place to control project management and cost overruns, and to ensure that their companies are being compensated for all work performed.

“Just get it done” makes a company profitable in the short run. “Get it done right” makes for a stable and profitable company in the long run. Accurate and reliable financial information not only allows companies to make good management and bidding decisions, it also helps maintain credibility with lenders, customers, and sureties.

So, monitoring systems should be in place to ensure that job costs are in line with projections and that the original levels of productivity are being met.

Don't Adjust – Manage!

Proactive job monitoring allows for change-order management, rather than claims adjustments. Remember: Change orders can be recognized as income as you progress throughout the job; claims are “sunk” costs that can only be recognized after they are settled with the owners or other contractors.

In addition, good monitoring systems not only minimize the number of claims, they also strengthen your company's

position if and when a claim must be filed. These systems include a methodology for collecting data as the job progresses (preferably on a daily basis), as well as oversight processes to analyze all input and provide feedback to field management.

Expensive computer programs can't do it alone; they must be supplemented with appropriate paper flow and information controls. Keep in mind that organized and documented contemporaneous support is hard to dispute.

Get What's Due

Many construction companies have trained their customers to buy on price, while expecting extraordinary service. Given these expectations, coupled with a "rush-rush" environment and consistent labor shortages, your company's exposure to work outside the scope of the original contract could be significant.

The amount of unrecoverable revenue at the end of projects has increased due to the "get it done now" mentality, even when budgets are constrained or fixed. The absence of change-order and scope-change management can cause erratic recognition of revenue in the job early on and margin fade as the job completes. Managing the process of recognition and billing will prevent your company from getting left with unreimbursed costs.

Those contractors who are able to control their billing (cash flow and potential revenue) and change-order processes as each job progresses will be properly compensated for their efforts. These companies will reflect a realistic recognition of revenue and will not deliver unwelcome surprises to the users of their financial statements.

Company-Wise Incentives

As a way to retain key personnel, many construction firms have developed creative incentive plans that tie an employee's financial success to results he or she can control. The good news: The quarterly measurement of these incentives creates the best option for motivating people. The bad news: It also presents the largest risk for revenue manipulation.

For example, if employee bonuses are calculated based on revenues, there may be a tendency to be optimistic and aggressive in reporting revenue. So, ensure that sound oversight systems are in place that can predict revenue manipulation and that account for fluctuations in the recognition of revenues as jobs near completion.

Timing Is Everything

Controlling the timing of revenue has been an art in the construction industry for many years. Both the SEC and AICPA would like to ensure that companies do not use the conservative "cookie-jar" approach, which allows a contractor to "put money away" from their current work-in-progress for another day.

However, the focus has shifted away from this conservative position; increasingly, the goal is to make financial statements more accurate. In fact, using an overly conservative revenue-recognition process flies in the face of current proposals to stop revenue manipulation.

If you are challenged for taking the conservative approach, spend time analyzing the need for and the appropriate level of contingencies in your job-cost analysis. Accuracy in the estimation process will be an important feature in the production of meaningful financial data.

The IRS Factor

The IRS has long recognized that contractors can be very conservative when it comes to estimating their current year revenue for income tax purposes. Accordingly, Congress enacted the "look-back" calculations to correct the perceived timing shift of tax payments on this revenue.

However, the implications of look-back for financial statements and company/industry trends are far-reaching. When revenues are not uniformly reported, company trends (used to evaluate credit worthiness and bonding capacity) are skewed, and the contractor's financial information will eventually be considered unreliable.

Consider this: As the public accounting industry is looking carefully at the timing of revenue and the prevention of recording revenue earlier than appropriate, the IRS is moving to accelerate the recognition of revenue. Through its new regulations governing IRC section 460, the IRS is redefining the point at which income must be recorded.

Moving at Cross-Purposes?

New regulations promulgated in connection with IRC section 460 seem to have taken the position that "close enough is good enough." The new position on substantial completion of projects cuts the recognition of all contract revenue off at a point when the project is substantially complete (say 95%) or when the customer begins using the property. This is much earlier than under the old regs (which used the point at which the project was accepted), and is totally opposite the direction in which the accounting profession is moving.

The IRS is also taking a dim view of the use of contingencies in the recognition of revenue, requiring that revenue be recorded at the time a company can reasonably determine the amounts due, and not at the time the event occurs or the cash is received.

This recognition of revenue standard is also totally opposite the direction in which the public accounting profession is moving. In fact, we are getting closer to having two separate accounting systems: one for the recognition of book income and the other for the recognition of taxable income. Remember the old joke about keeping two sets of books, the real one and the other one used for taxes? It's no joke.

Independence Issues

As mentioned at the beginning of this article, the other hot topic in accounting circles these days is the “independence” of external auditors. The relationship between public accountants and their clients is coming under very intense scrutiny.

Due to the high-tech availability of information, the range of services public accountants can bring to their clients has increased dramatically. Some of these services (particularly consulting services) may be deemed inappropriate if they compromise the independence outsiders assume is present in an auditor’s report. And, perception of a lack of independence could affect non-public companies and how they are regarded by financial institutions and sureties.

For this reason, the independence issue has become very contentious, pitting accounting firms against each other, and the AICPA against the SEC. Clearly, there will be changes to the independence rules; their nature and extent will affect not only accounting firms, but also their clients – including construction companies.

Choosing Sides

Independence is a concept generally governed by the AICPA through its own rules and regulations. Increasingly, the SEC wants to tighten both the parameters and the rules governing the concept. In fact, the SEC and Arthur Levitt, Chairman of the SEC Enforcement Division, feel so strongly about this issue that they have vowed to go to Congress if they cannot convince the AICPA to accept its position. On the other hand, accounting firms have already begun to lobby Congress to legislate in the AICPA’s favor. While it appears that the two sides will come to some agreement to avoid legislation, this issue will remain on the front burners for a long time to come.

Diminishing Services & Increasing Costs

We live and work in an environment where consolidation and one-stop shopping are the future of the financial and professional services community. The definitions of “consulting” can be broad and can include any number of services, such as advice on internal controls and computer systems consulting.

Many within the SEC contend that accounting firms should not provide *any* consulting services to assurance clients. However, stricter independence rules limiting the services a professional firm can provide could raise the cost of the remaining assurance services. For example, there are synergies, efficiencies, and cost savings associated with having consultants and advisors who know your company.

Knowledge, after all, is what makes a consultant/advisor valuable to an organization.

If accounting firms are prevented from providing consulting services, the customer must reeducate a separate advisor in order to get value from whatever ideas are proposed. This education costs the client time to get the consultant up-to-speed and time to explain the context of the project (the historical information), which ultimately diminishes the value of the final product.

In addition, the price of compliance services (the run-of-the-mill audit) will rise as the more flexible and lucrative consulting services are peeled away. The services that survive this new proposal are the ones that expose the accounting firm to the most risk, both financially and legally. Therefore, given the economics, it is likely that the prices commanded by public accounting firms will increase.

A Few Last Thoughts ...

The AICPA and the accounting profession are currently wrestling with this issue and positions appear to have softened somewhat. But, as has happened with other issues (such as detecting fraud in audits), independence may become a regulatory favorite of Congress. So, for the time being, keep your eye on the story as it unfolds to assess its potential impact on your company.

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