Percentage-of-Completion Method is gone:
Impact of new rules start in 2019

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New reporting rules will impact contractors' financial statements and the main users of their financial statements; namely, sureties and lenders. The organization that establishes the methods and principles by which CPAs prepare financial statements have un-done almost 40-years of reliance on the percentage-of-completion method for reporting long-term contracts. For non-SEC companies, the rules go into effect calendar year 2019.

Industry stakeholders are concerned whether the new rules will increase financial statement complexity, add to administrative costs, or possibly reduce standardization of reporting. Moreover, there's anxiety that the new rules could reduce financial statement credibility or worse, result in financial statements that users are unprepared to evaluate.

Like all changes, the starting point is learning and understanding the new rules. After a couple of years, the 2019 hurdle to adopt these new requirements may not even be noticeable.

GAAP and How We Got Here

Generally Accepted Accounting Principles (GAAP) is the financial framework of rules and principles that dictate how financial statements are prepared in the United States. GAAP is overseen by the Financial Accounting Standards Board ("FASB"). FASB, under pressure from the SEC to unify US GAAP with 'International Standards' developed the new rules over the last decade. This resulted in the Standard generally known as "Topic 606" that was published, after several drafts, in 2014. Public companies started reporting to the SEC under the new rules during the first quarter of 2018, and now privately-owned contractors will start the new reporting regime with their 2019 calendar year-end financial statements.

While the typical privately-owned construction company rarely needs to worry what the SEC or FASB has to say about their reporting practices – the contractor does need to care about GAAP. That's because in most all situations, GAAP adherence is required by sureties, banks, and governmental agencies such as Florida Department of Transportation, the U.S. government and the like. The bottom line is that changes in GAAP do impact many contractors.

For almost 40 years, contractors followed the percentage-of-completion method (PCM), which was formally established in 1981. Fundamentally, we should recognize that technically the PCM has been eliminated by the newly issued standard. The new rules still permit long-term contracts to use methodology similar to PCM, but it has been modified.

How does this affect your construction company?

Here are a few of the types of changes you will need to understand for reporting under the new Revenue Recognition Standard:

Unpriced change orders: These are now called “unapproved contract modifications,” and you may have some new flexibility with the ability to recognize gross profit before a change order is even signed. Under current rules, you do not recognize gross profit until you have that change order in hand and signed.

“Performance obligations” (part of the new terminology) are required to be separated as subsets of a contract. That is, rather than reporting under one contract, segmentation and reporting for each so-called performance obligation may be required.

There are new methods for evaluating contract price and contract costs “as you go.” But much of the old PCM methodology for measuring progress – with modifications - can still be used.

Footnote disclosures are changing and expanding.

For 2019, a decision is needed as to how to transition to the new standard: full retrospective approach or modified retrospective approach.

Where to Begin?

Before 2019 ends, all contractors will need to begin the transition process. Here are a few guidelines to consider:

First and foremost, management must understand the new requirements. Accordingly, management must evaluate the level of education and training your team needs.

Next, analyze and determine what areas of the business the new standard will impact. Is it just financial reporting? Or will the new standard impact your company’s IT requirements, operations, taxes, how contracts are drafted, and so on. A strategic perspective should be utilized.

And, importantly, assemble a team to help you get ready. This likely includes your chief operating officer, chief financial officer and/or controller, your outside CPAs and auditors, and possibly outside consultants. Establish a project plan for your transition with deadlines and tasks for all stakeholders.

The fundamental fact is: If you require a GAAP statement, then you’ll need to address the transition for reporting under the new standard to be ready when your outside CPAs or auditors arrive in early 2020.

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Shavell & Company helps contractors with bonding maximization, cash flow analysis, tax structuring and planning, litigation support, business valuation, and cost segregation studies. Shavell is an author of the Income Recognition chapter in CFMA’s guide, “Financial Management and Accounting for the Construction Industry,” published by Matthew Bender Elite Products. He has testified six times before Congress and five times before the IRS on legislation and proposed regulations impacting the Construction Industry. Mr. Shavell is a four-time winner of the South Florida Business Journal award for accountants in construction, real estate, and tax categories.