

CNA/SCHINNERER CONTRACTOR'S DESIGN PROFESSIONAL LIABILITY PROGRAM



Accounting for Changed Work by Lisa Nadolski

A federal district court in Texas is currently presiding over a potentially seminal case questioning accounting practices for construction contracts.

In July 2002, Judicial Watch sued Halliburton Company, several of Halliburton's current and former officers and directors and its accounting firm, Arthur Andersen. The suit alleges, among other things, that Halliburton violated Generally Accepted Accounting Principles (GAAP) by reporting unbilled receivables from "unapproved and disputed cost overruns, change orders, and unresolved claims, without disclosing the Change in Accounting Principle." Currently, the Court is considering Halliburton's motion to dismiss. In light of the pending case and the multiple accounting scandals of the past few years, this seems an opportune time to examine the appropriate accounting standards for contract changes and claims.

Under GAAP, there are two methods of accounting for construction contracts: the percentage-of-completion method and the completed contract method. Under percentage-of-completion, income is recognized as work on a contract (or group of closely related contracts) progresses. Under the completed contract method, income is recognized only when the contract is complete, or substantially complete. The percentage-of-completion and completed contract methods are not alternative methods for similar circumstances. Rather, the percentage-of-completion is the preferred method when estimates of costs to complete and extent of progress toward completion are reasonably dependable. For this reason, the percentage-of-completion method is preferable in most commercial construction contracts. Changing accounting methods from the percentage-of-completion to completed contract method, or vice versa, must be disclosed in financial statements.

In situations where both the scope of the change order and the price are mutually agreed upon, revenue and costs should be adjusted to reflect the change order. However, if the price

associated with a change order has not been mutually agreed upon, separate procedures are used depending on the accounting method. Under the completed contract method, costs attributable to unpriced change orders should be deferred as contract costs if it is probable that total contract costs, including costs attributable to the change orders, will be recovered from contract revenues.

Under the percentage-of-completion method, accounting for costs incurred in connection with unpriced change orders depends on the likelihood and extent of recovery. If it is *not probable* that the costs will be recovered through a change order, costs attributable to unpriced change orders should be treated as costs of contract performance in the period in which the costs are incurred. If it is *probable* that the costs will be recovered through a change in the contract price, the costs should be: (1) deferred (excluded from the cost of contract performance) until the parties have agreed on the change in contract price; or (2) treated as costs of contract performance in the period in which they are incurred, and contract revenue should be recognized to the extent of the costs incurred. However, if it is probable that the contract price will be adjusted by an amount *exceeding* the costs attributable to the change order and the amount of the excess can be reliably estimated, the original contract price should also be adjusted by the amount that the costs recognized as costs of contract performance.

When can a contractor book a claim as revenue?

Additional contract revenue arising from contract claims may be recognized in accordance with GAAP if it is likely that the claim will yield additional revenue in an amount that can be reliably estimated. To recognize this revenue, four requirements must be met:

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1. The contract or other evidence must provide a legal basis for the claim; or there must be a legal opinion stating that under the circumstances there is a reasonable basis to support the claim;
 2. Additional costs are caused by circumstances that were unforeseen at the time of contracting and are not the result of deficiencies in the contractor's performance;
 3. Costs associated with the claim are identifiable or otherwise determinable and are reasonable in view of the work performed; and
 4. The evidence supporting the claim is objective and verifiable, not based on subjective analysis or unsupported representations.
1. What accounting method has been utilized to date on the project and which method is appropriate in the circumstance?
 2. Is agreement between the contractor and the owner regarding the scope and cost/price impact of changed work likely?
 3. In the case of a disputed change, is there objective and verifiable evidence to support the claim and is legal counsel willing to offer a supportive opinion?

If all these requirements have been met, revenue may be recorded but only to the extent that contract costs relating to the claim have been incurred.

Accounting for change orders and contract claims is complex, and the consequences of violations of GAAP may be severe. The opinion in the Halliburton matter could shed more light on GAAP requirements for "booking" contract claims as revenue. In the meantime, contractors should carefully consider the following in determining how and when to account for revenue from change orders and contract claims:

Answers to these complicated questions are rarely susceptible to simple responses. Therefore, contractors would be wise to consult with their legal and accounting professionals to ensure compliance with applicable accounting rules, procedures, and practices.

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GAAP Principles

The three main GAAP principles that apply to construction contracts:

- (1) Accounting Principle Bulletin No. 20, *Accounting Changes*
- (2) Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*
- (3) Statement of Position No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*