



BEING OVERLY OPTIMISTIC ABOUT CHANGE ORDERS AND CLAIMS CAN BE HAZARDOUS TO YOUR FINANCIAL HEALTH



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Being overly optimistic about change orders and claims can lead to significant problems for a construction company. Contractors that continually realize less profit from jobs than they originally estimate can see their ability to bid on larger jobs hindered by bonding issues, and their financial stability adversely affected.

Change orders are modifications to an original contract that effectively change the terms of the contract. Change orders may be initiated by either the contractor or the customer and include modifications to the:

- Specifications
- Design
- Method or manner of performance
- Facilities
- Equipment
- Materials
- Sites
- Period for completion of the work

There are three types of change orders:

1. Approved – both parties have approved the scope and price of the change.
2. Unpriced – the work to be performed is defined and the adjustment to the contract price is agreed to at a later date.
3. Unapproved – neither party has agreed to the scope and/or price of the change.

Careful evaluation of the specific facts and circumstances of the change order is required before including it in the estimated contract revenue. In the case of an approved change order, the contract revenue and costs should be adjusted.

Accounting for unpriced change orders is more difficult. Under the completed-contract method, costs attributable to an unpriced change order should be deferred as contract costs if it is probable that all costs attributable to the change order will be recovered from contract revenues. Some of the factors to consider in evaluating if recovery is probable are whether or not the contractor has the customer's written approval for the change order, documentation on the costs, and the contractor's track record of successfully negotiating change orders.

Under the percentage-of-completion method the 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 *not* probable that the costs will be recovered through a change in the contract price. In this case there is no change in contract revenue and percentage completed when the costs are incurred and recognized. The costs should be deferred as an asset and excluded from the cost of contract performance until the parties have agreed on a price.

Alternatively, if it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the change order *and* that amount can be reliably estimated, the original contract price should be adjusted when the costs are recognized as costs of contract performance if its realization is probable. However, since it is difficult to estimate future revenues, the income from unpriced change orders should only be recorded in circumstances in which realization is assured beyond a reasonable doubt, such as when an entity's historical experience provides such assurance or the contractor has received a bona fide pricing offer from a customer.

If change orders are in dispute, they should be evaluated as claims. Claims are amounts in excess of the agreed contract price or amounts not included in the original contract price that a contractor seeks to collect. Claims can be made for customer-caused delays, errors in specifications and designs, contract terminations, change orders in dispute or unapproved as to both scope and price, or other causes of unanticipated additional costs.

Accounting for a change order depends on why it occurred. For example, if a contractor has to use more concrete or a different machine on a particular job, they will likely have to do a change order, which may not be approved by the customer. In this case, documentation of the change order is very important, especially if the company is audited. An auditor has to verify the collectibility of unapproved change orders that are the basis for additional revenue, such as an original contract of \$1 million which is treated as \$1.1 million.

If confirmation of the amount of the change order by the customer is not possible, the auditor will need to obtain other forms of documentation to support the change order.

From an accounting perspective, the additional \$100,000 of revenue and the related asset that the contractor puts on their books needs to be solid. However, many times the construction company is optimistic and assumes that they will realize the additional revenue. Often considerably less money than is expected is realized and the company incurs a profit fade on that job.

Surety agents that back construction companies do not like to see profit fades or reductions of the estimated gross profit over the life of a contract. Subsequently, the bonding company may reduce the amount of the bond they're willing to issue for the construction contractor. For example, a company's working capital (current assets minus liabilities) may be \$1 million. The surety may bond the construction company for ten times their working capital or \$10 million. That means the construction company can bid on jobs up to the \$10 million bonding capacity. If, because of the contractor's history of having profit fades, the bonding company identifies assets that they do

not consider recoverable, they will subtract or discount them from the balance sheet, limiting the company's bonding capacity and its ability to bid higher priced jobs.

As one of the leading accounting and consulting firms for the construction industry, Cowan, Guteski & Co., P.A. understands how accounting for change orders can affect your profitability and ability to grow your business. Contact Bill McNamara, CPA - Director of the Construction Services Group at 732-349-6880 extension 116 or bmcnamara@cowanguteski.com for more information on accounting for change orders.

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