



# CONTRACTOR

JANUARY/FEBRUARY 2022

Construction accounting

**The finer points of a  
classified balance sheet**

**Look into licensing  
before bidding out of state**

**9 common insurance  
policies for contractors**

**Survey says: It's time for a  
digital transformation strategy**



415 Sargon Way • Suite J • Horsham, PA 19044

Tel: (215) 675-8364 • Fax: (215) 675-3879

[www.wm-cpa.com](http://www.wm-cpa.com)

Knowledgeable • Proactive • Caring • Responsive

## Construction accounting

# THE FINER POINTS OF A CLASSIFIED BALANCE SHEET

Clear, accurate and properly created financial statements can go a long way toward helping a construction company owner run a successful business. One way that contractors can help themselves and those who read their financial statements is by creating a classified balance sheet. Let's take a closer look at what this is and why it's important.

### General criteria

The difference between a classified balance sheet and a conventional one is that a classified balance sheet distinguishes current assets and current liabilities from other (that is, noncurrent) assets and liabilities. This approach is particularly well-suited to construction businesses because of the project-by-project nature of their operations. The general criteria for separating current and noncurrent items are:

**Operating cycle.** This is traditionally defined as the time needed to convert cash into materials and services, and then into products, which are then sold to create receivables. Finally, these receivables are converted through collections back into cash. (A construction company's operating cycle works a little differently at first but ends up in the same place as other businesses.)

**Current assets.** These are cash and other items that are reasonably expected to be realized in cash or sold or consumed during one year (or within the company's normal operating cycle if it's longer than a year).

**Current liabilities.** These are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities.

### WHAT YOUR SURETY WANTS FROM YOUR FINANCIAL STATEMENTS

One party that likely appreciates a classified balance sheet is your surety. Bonding providers use financial statements and supplementary schedules to assess the financial stability of a contractor and to evaluate the company's earnings trend.

Sureties typically want financial statements that, first and foremost, conform to Generally Accepted Accounting Principles rather than an ad hoc or special purpose framework. They also usually require comparative statements, often covering a three- to five-year period.

Finally, sureties typically prefer audited financial statements. Some, however, may accept reviewed or compiled annual financial statements.

Although construction companies often have contracts of varying duration, the normal operating cycle is measured by the average time between the inception of a contract and its completion. When determining a normal operating cycle, using estimated time remaining to complete contracts is incorrect.

For example, if you usually operate under contracts lasting 18 to 24 months, and most of the contracts have six to nine months remaining to completion at year end, your normal operating cycle would still be 18 to 24 months.

### Different operating cycles

The contracts of most small construction businesses can generally be completed in one year or less. Although a company such as this may present an

unclassified balance sheet, a classified one is preferable. If some assets and liabilities are classified as noncurrent because the related contracts have terms of greater than one year, information about their realization and maturity should be disclosed.

In most other industries, an unclassified balance sheet is preferable when the operating cycle exceeds one year. Certain construction companies may use this approach, but the preferable practice is to classify contract-related assets and liabilities as current based on the operating cycle concept and to classify other assets and liabilities as noncurrent. (Amounts expected to be realized or liquidated during the year would still be classified as current.)

### Assets and liabilities

For construction companies, contracts represent a primary source of assets and liabilities. How these two elements are represented on a classified balance sheet underwent a major transformation under the Financial Accounting Standards Board's Accounting Standards Codification Topic 606 (ASC 606), *Revenue from Contracts with Customers*.

According to ASC 606, a *contract asset* is defined as an entity's right to consideration in exchange for goods or services transferred to a customer when that right is conditioned on something other than the passage of time. Meanwhile, a *contract liability* is defined as an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Unbilled contract receivables, for instance, are now considered contract assets, as are costs and estimated earnings in excess of billings. Equipment and small tools specifically bought for, or expected to be used solely on, an individual contract are typically defined as contract assets as well.

Billings in excess of costs and estimated earnings are now generally considered contract liabilities. If billings exceed total estimated costs at completion of the contract plus contract profits earned to date, the excess can be classified as deferred income.

### Retainage issues

ASC 606 has a profound effect on retainage as well. A contractor needs to assess how to properly

	Actual	Budget	Last Year	%
Goods sold	89,519,982	89,034,853	88,549,724	
	(236,397)	(235,116)	(233,835)	
	89,283,585	88,799,737	88,315,889	
Income	4,219,893	3,877,538	3,535,183	
Expenses	1,893,167	1,504,198	1,115,229	
Income	1,375,595	1,276,853	1,178,183	
Expenses	3,484,815	2,544,603		
	96,037,160			

**Balance Sheet**

**ASSET**

Current asset

- Cash
- Account Receivable
- Bill of exchange
- Inventories
- Prepaid expenses

Total current asset

Long-term receivables

Capital asset

Total Asset

**LIABILITIES**

Current liabilities

Line of credit

classify retentions as either receivables or contract assets. For instance, if there are restrictive provisions in the contract related to retentions, such as fulfillment guarantees, then those retentions are contract assets rather than receivables. Retentions should be classified as receivables only when the contractor's right to the retention is unconditional (that is, subject to only the passage of time).

Retainage is determined at the contract level; therefore, some retentions may be classified as contract assets while other retentions are classified as receivables because the net right is conditional on some contracts and not conditional on others. A retainage payable is still considered a current liability, just like before ASC 606, and should be reported as such on a classified balance sheet.

### Keeping tabs

It's important for construction business owners and executives to keep tabs on their assets and liabilities, including how these items are being defined for financial reporting purposes. Your CPA can answer any questions you may have about classified balance sheets or other accounting matters. ■

# LOOK INTO LICENSING BEFORE BIDDING OUT OF STATE

Construction companies that work near one or more state borders may eventually want or need to bid on out-of-state projects. Should you win one of those jobs, you'll have a lot to think about. How will we get our workers there and our supplies delivered? Yet, before you can even answer those questions, you'll need to back up even further to determine just how you'll get licensed.

## Assessing the requirements

Contractors who put off licensing until they land their jobs may be in for an unpleasant surprise: Some states allow only licensed contractors to bid on work. Licensing requirements for bidders may depend on a project's size. One state may require that contractors be licensed if they're bidding on a project that's, say, \$50,000 or more, while another may set the cutoff at \$25,000 or more.

The lead time required for licensing also varies widely, which can trip you up if you want to start a job quickly. Some states review license applications only during official meetings, and those meetings may be held quarterly. If your job is time-sensitive, check on the state's licensing timetable so you don't miss a deadline.



## Navigating the process

When it comes to performing the work, each state has its own twist on the licensing process — so research the details closely. Not all states require licenses for contractors, and license requirements may vary based on the municipality where you'll be working and the scope of work.

Some states allow only licensed contractors to bid on work.

In some states, a license to work isn't required if a job falls below a certain dollar threshold. That threshold varies from state to state — for example, it might be only \$2,000 or it might be \$50,000.

Other states don't license contractors at the state level but have alternative requirements that you'll need to meet. For example, you could be required to register with the state and then apply for licenses in the specific towns or counties where you'll be working.

While you're researching the specifics, don't forget your subcontractors (assuming you're a general contractor). Some states require subs to be licensed separately — even if they're working under a general contractor's supervision. Other states require licenses only for certain trades, such as plumbing or electrical work.

## Doing the paperwork

When you apply for an out-of-state license, prepare for a mountain of paperwork. Some commonly requested documents for license applications include financial statements prepared by your CPA and summaries of your assets, including equipment.

You could also need copies of your general liability and workers' compensation insurance certificates that list the state licensing board as an additional insured. Some states might ask for references from your suppliers. If you're involved in any lawsuits or a disciplinary action has been taken against you, you'll likely need to provide a detailed explanation.

States also typically require contractors to qualify to do business in the state, and obtain a tax identification number, before they'll issue a license. In addition, you may need to take exams or participate in training.

Certain states have license reciprocity agreements with one another. This means that, if you're licensed in one state, you may qualify for a license in a reciprocating state without having to sit for that state's trade exam. While reciprocity doesn't mean you'll be automatically waived in, it generally accelerates the licensing process a bit.

Obtaining an out-of-state license also means dealing with related tax and financial issues. Some states and municipalities assess an annual license tax based on a percentage of the



contractor's gross receipts, while others charge an annual fee that goes toward a recovery fund for project owners who have financial disputes with licensed contractors.

### Covering all the details

Naturally, licensing is just one piece of the puzzle. You'll also need to sort out the payroll, property, and sales and use taxes you may owe for the out-of-state project. Work with your CPA and attorney to ensure that you've covered all the details. ■

## 9 COMMON INSURANCE POLICIES FOR CONTRACTORS

Construction companies need insurance, but what kind? The answer depends on the size and structure of your business, industry hazards and geographic area, contract agreements, and even a project's specifics. To help you assess what you have and what you might need, here's a review of nine common insurance policies for contractors:

**1. Workers' compensation.** A strong workers' comp policy is essential, and often mandatory, for any

business with employees — but especially for construction companies, whose workers face high injury risk. Coverage provides wage compensation and assistance with medical bills for on-the-job injuries or illnesses while protecting the employer from related lawsuits.

**2. General liability.** Often called commercial general liability, this policy covers damages and legal costs associated with third-party injuries (not to employees) and property damage claims caused by your company or a faulty product you installed. It won't pay to repair faulty work but can cover the resulting damage.

**3. Builder's risk.** This coverage provides financial protection against damage done to a structure still under construction — including costs resulting from fire, vandalism, weather, and on-site tool or equipment theft.

**4. Professional liability.** This is also called an errors and omissions policy. It covers legal costs when a contractor is sued over a mistake, such as using the wrong materials.

**5. Umbrella.** These policies provide supplementary coverage that absorbs costs exceeding the liability limits of another policy. Say you take on a project for which you're contracted to carry \$3 million of general liability insurance, but your insurance provides only \$1 million of coverage. You could buy umbrella insurance for the remaining \$2 million. Doing so may cost less than increasing the limit of your primary policy.

**6. Commercial property.** This type of policy safeguards your construction company's physical property — including tools, computers, signage and furniture — in the event of fire, broken pipes, bad weather, theft or vandalism. If you don't need property insurance but want your equipment protected, a contractor's tools and equipment (sometimes called inland marine) policy may be ideal.

Your company's insurance needs can change as your business grows or you move into other specialty areas.

**7. Commercial auto.** Commercial vehicles require separate auto insurance coverage because they're exposed to more risk than personal vehicles. This coverage provides both liability and physical damage protection for fleet vehicles including cars, trucks and vans. Some policies cover legal fees and the medical costs of others if an employee is at fault in an accident.



**8. Cyberinsurance.** Cyberattacks, such as ransomware, are a real, growing threat to businesses. At minimum, this policy covers liability for a data breach involving sensitive customer information — credit card numbers, drivers' license numbers and so forth — that results in fraud or might reasonably be expected to cause it.

**9. Bonding.** Some project owners may require various types of surety bonds to guard against incomplete or faulty construction services. Being bonded means your construction business is financially sound enough to perform the work and won't leave the customer holding the bill.

Your company's insurance needs can change as your business grows or you move into other specialty areas. Work with an agent who understands the nuances of the construction industry and can help you identify must-have coverage. Your CPA can help you evaluate the costs. ■

# SURVEY SAYS: IT'S TIME FOR A DIGITAL TRANSFORMATION STRATEGY

A recent report found that 92% of construction project owners and 96% of contractors across the globe have a digital transformation strategy in place. Essentially, this means they're transforming their businesses into "digital enterprises."

A digital enterprise is simply one that does as much as possible electronically — from administrative tasks such as payroll and invoicing to collecting data in the field to managing and closing out projects. The goal is to make information easily accessible and readily usable to any authorized party who needs it.

With the tide turning for technology adoption in the construction industry, it's time for contractors still wading through paper or struggling with old tech to catch up before they fall behind the competition.

## What are the results?

The report, *Global Capital Projects Outlook 2021*, is based on a survey of 300 large-enterprise, capital project owners and construction professionals across the globe. Commissioned by construction software company In Eight, the survey was conducted online during February and March 2021.

It found that nearly two-thirds (63%) of contractors in the Americas say project management software and artificial intelligence/machine learning are critical to their success in the next one to three years. Half also list building information modeling as critical to success.

About 96% of those surveyed say technology can improve productivity, while 71% think it already has led to improvements.



## Why transform?

When you replace paper processes with digital methods, you can eliminate the messy inefficiencies that come with manually logging and filing information and, later, having to hunt down hard copies in filing cabinets or storage rooms.

Plus, when you use integrated digital tools that can "speak" to each other — such as cloud-based software and mobile apps — project team members can more easily share and update information in real time. Thus, they can make informed decisions faster.

The report encourages widespread rollout of enterprise-level mobile software across construction company operations to improve productivity and collect and distribute data more holistically.

In addition, the right digital tools enable project partners to collaborate while remaining physically distanced, which became necessary when the COVID-19 pandemic hit and, in many cases, remains important during ongoing efforts to prevent the spread.

## Are you ready?

The construction industry is in a tech boom right now, with innovative providers offering à la carte solutions applicable throughout a project's lifecycle. Of course, that doesn't mean you should throw money at IT products and services without careful

forethought. Every contractor's approach to digital transformation should suit its size, budget and distinctive needs. It's okay to start small. ■



415 Sargon Way • Suite J • Horsham, PA 19044  
Tel: (215) 675-8364 • Fax: (215) 675-3879  
[www.wm-cpa.com](http://www.wm-cpa.com)

### **About Wouch, Maloney & Co., LLP**

Wouch, Maloney & Co., LLP is a regional certified public accounting firm with offices in Horsham and Philadelphia, Pennsylvania and Bonita Springs, Florida. The firm has provided closely held business and individual clients with a wide array of accounting services for over 30 years. Wouch, Maloney & Co.'s domestic, multi-state and international clients reflect a broad range of industries from real estate and construction to manufacturing, wholesale and professional service. The firm offers a comprehensive group of services including tax, audit and accounting, business consulting, estate planning, business valuation, litigation support and forensic accounting.

### **Serving the Construction Industry**

Wouch, Maloney & Co., LLP prides itself on its niche practice in the construction industry. The majority of our clients are involved in construction and we are adept at recognizing and solving problems common to that industry. For over thirty years, we have represented contractors along with commercial and home builders in Pennsylvania, New Jersey and Florida.

- We develop **relationships with lenders and bonding agents** and understand how to present your financial picture in their preferred format.
- We assist you in **keeping a close eye on debt, cash flow, profit margins** and other measures of financial health.
- We prepare **contracts in progress** schedules that management can understand which clearly illustrate gross profit, job costing and over/under billings per job.
- We have highly trained staff with **expertise in construction accounting** who are detail oriented, but who do not lose sight of the larger goal which is to provide our clients with quality services to meet their many financial needs.

