Construction Update
FICPA Southwest Florida Chapter
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Today’s Agenda

- The Contractor/Surety/Owner Surety Relationship
- How Sureties Evaluate a Contractor’s Bonding Capacity
- Suggested Contractor Financial Statement Presentation and Disclosures
- “Best of Class” Contractor Benchmarks
- Risk Analysis and Cost to Complete
- Use of Data Extraction Software in Contractor Audits
- Contractor Tax Methods
- Contractor Internal Budgeting (time permitting)

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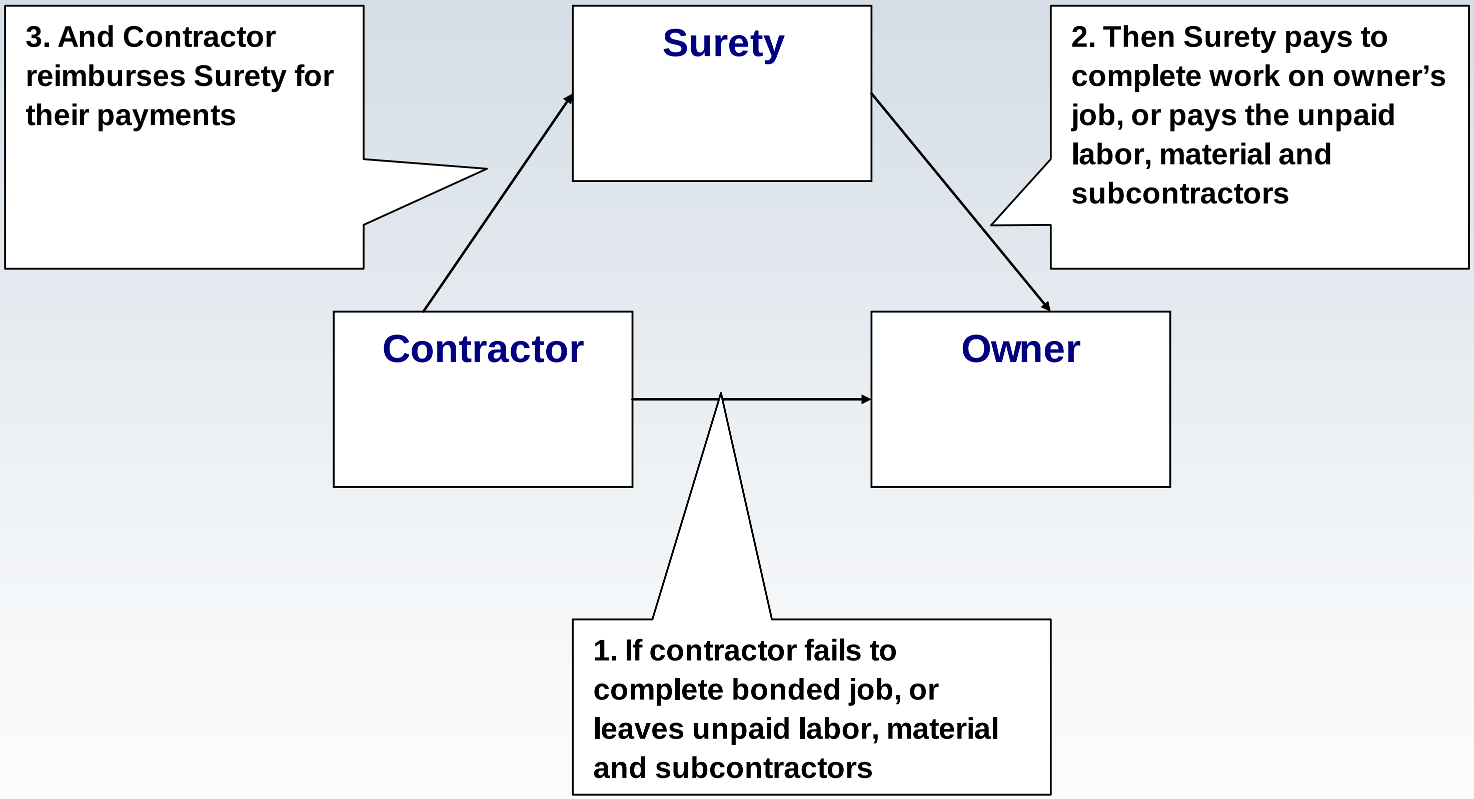
The Contractor/Surety/Owner Surety Relationship



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How Sureties Evaluate Bonding Capacity

- Financial stability is one of the most important factors in obtaining surety credit.

- While most clients focus their attention on their income statement, the most important section of their financial statement to a surety is the balance sheet.

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Key Financial Ratios for Sureties

- Working Capital: Current Assets minus Current Liabilities

- Adjusted Working Capital: Working Capital from above, less adjustments to back out unproductive current assets such as:
  - Shareholder, officer, and related party receivables
  - Prepaid Expenses
  - Some portion of inventory (often 50%) that is not on a job site
  - Under billings
  - Bond programs are usually based on some multiple of (often 10 times) adjusted working capital

- Liabilities to Equity
  - The ratio of all company liabilities and debt to stockholder equity. As a general rule, sureties like to see a ratio of 2 to 1 or less.

Example Surety Adjusted Working Capital

Current Assets		
Current Assets - GAAP Basis	$	X,XXX
Subtract:		
Receivables from officers, employees, owners		(XXX)
50% of inventory not at job site		(XXX)
Prepaid expenses		(XX)
Add:		
Cash surrender value of life insurance		XX
Current Assets - Surety Credit Purposes		X,XXX
Current Liabilities		
Current Liabilities - GAAP Basis		
Adjusted Working Capital for Surety Credit	$	X,XXX

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Surety Financial Statement Users

- Sureties are some of the most sophisticated users of contractor financial statements
- Sureties need construction industry specific information in their underwriting process.
- Construction financial statements should go beyond the minimum GAAP required disclosures and present the additional information useful to sureties.

Presentation For Surety Use

- Financial Statements Break Out Items Needed For Surety Credit Analysis
  - Construction Industry Specific Note Disclosures
    - ◊ Accounts receivable and retainage by open and closed jobs
    - ◊ Outstanding bonds, backlog, pass through entity book tax differences
  - Supplemental information
    - ◊ Completed and uncompleted job schedules that reconcile to construction revenue and costs on the income statement
    - ◊ Detailed schedules of construction costs, general and administrative expenses, other income and expense

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Supplemental Information

Contract schedules should tie to income statement

STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010		2009	
	AMOUNT	PERCENT	AMOUNT	PERCENT
CONTRACT REVENUES EARNED	$ 18,500,000	100.0 %	$ 12,500,000	100.0 %
CONTRACT COSTS	16,280,000	88.0	11,050,000	88.4
CONTRACT GROSS PROFIT	2,220,000	12.0	1,450,000	11.6

SCHEDULE I - EARNINGS FROM CONTRACTS IN 2010
FOR THE YEAR ENDED DECEMBER 31, 2010

	Revenues Earned	Cost Of Revenues Earned	Gross Profit
Contracts Completed During 2010	$ 14,550,000	$ 12,730,000	$ 1,820,000
Contracts In Progress At Year End	3,950,000	3,550,000	400,000
	$ 18,500,000	$ 16,280,000	$ 2,220,000

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Job Schedules

SCHEDULE OF PERCENTAGE OF CONTRACTS IN PROGRESS AT DECEMBER 31, 2010

					Year Ended December 31, 2010				At December 31, 2010	
Job #	Contract	Contract Price	Total Estimated Cost	Estimated Gross Profit	Revenues Earned	Cost of Revenues	Gross Profit	Billings To Date	Cost & Estimated Earnings In Excess Of Billings	Billings In Excess Of Cost & Estimated Earnings
4	Underbilled Job	$ 7,850,000	$ 7,056,885	$ 793,115	$ 2,780,972	$ 2,500,000	$ 280,972	$ 2,230,972	$ 550,000	$ -
5	Overbilled Job	3,300,000	2,964,000	336,000	1,169,028	1,050,000	119,028	1,619,028	-	450,000
		$ 11,150,000	$ 10,020,885	$ 1,129,115	$ 3,950,000	$ 3,550,000	$ 400,000	$ 3,850,000	$ 550,000	$ 450,000

SCHEDULE OF COMPLETED CONTRACTS
YEAR ENDED DECEMBER 31, 2010

		Contract Totals			Before January 1, 2010			Year Ended December 31, 2010		
Job #	Contract	Contract Price	Cost of Revenues	Gross Profit	Revenues Earned	Cost of Revenues	Gross Profit	Revenues Earned	Cost of Revenues	Gross Profit
1	Completed Job	$ 10,000,000	$ 8,000,000	$ 2,000,000	$ 5,000,000	$ 4,000,000	$ 1,000,000	$ 5,000,000	$ 4,000,000	$ 1,000,000
2	Completed Job	5,000,000	4,730,000	270,000	-	-	-	5,000,000	4,730,000	270,000
3	Completed Job	4,550,000	4,000,000	550,000	-	-	-	4,550,000	4,000,000	550,000
		$ 19,550,000	$ 16,730,000	$ 2,820,000	$ 5,000,000	$ 4,000,000	$ 1,000,000	$ 14,550,000	$ 12,730,000	$ 1,820,000

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Contract Cost and Overhead Breakdown

SCHEDULE OF CONTRACT COSTS AND
GENERAL AND ADMINISTRATIVE EXPENSE
YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010			2009		
	AMOUNT	PERCENT		AMOUNT	PERCENT	
CONTRACT COSTS						
Materials	$ 5,250,000	28.4	%	$ 4,500,000	36.0	%
Labor	4,625,000	25.0		3,000,000	24.0	
Subcontract Expense	3,325,000	18.0		1,236,000	9.9	
Employee Benefits	1,295,000	7.0		810,000	6.5	
Payroll Taxes	465,000	2.5		310,000	2.5	
Equipment Rental	625,000	3.4		565,000	4.5	
Gas, Fuel, Oil	375,000	2.0		354,000	2.8	
Depreciation	320,000	1.7		275,000	2.2	
Total Contract Costs	$ 16,280,000	88.0	%	$ 11,050,000	88.4	%
GENERAL AND ADMINISTRATIVE EXPENSE						
Salaries and Wages, Office	$ 768,000	4.2	%	$ 646,000	5.2	%
Payroll Taxes	40,000	0.2		39,000	0.3	
Employee Benefits	75,000	0.4		70,000	0.6	
Retirement Plan Contribution	50,000	0.3		40,000	0.3	
Office Facilities Expense	300,000	1.6		300,000	2.4	
Office Supplies and Expense	7,000	0.0		5,000	0.0	
Provision for Uncollectible Accounts	70,000	0.4		10,000	0.1	
Depreciation	30,000	0.2		25,000	0.2	
Total General and Administrative Expense	$ 1,340,000	7.2	%	$ 1,135,000	9.1	%

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Example Consolidating Schedules

ASSETS	Sample Contracting Company, Inc.	Sample LLC	Eliminations	Consolidated
CURRENT ASSETS				
Cash and Equivalents	$ 180,000	$ 3,000	$ -	$ 183,000
Securities Available-for-Sale	555,000	-	-	555,000
Contract Receivables, Net of Allowance	3,225,000	-	-	3,225,000
Accounts Receivable Other	250,000	-	(125,000)	125,000
Inventory	165,000	-	-	165,000
Costs and Estimated Earnings in Excess of Billings				
on Uncompleted Contracts	550,000	-	-	550,000
Prepaid Expenses	33,000	4,000	-	37,000
Deferred Income Taxes	15,000	-	-	15,000
Total Current Assets	4,973,000	7,000	(125,000)	4,855,000
PROPERTY AND EQUIPMENT				
Property and Equipment	2,795,000	-	-	2,795,000
Accumulated Depreciation	(1,435,000)	-	-	(1,435,000)
Net Property and Equipment	1,360,000	-	-	1,360,000
OTHER ASSETS				
Management Fee Receivable	-	3,000,000	(3,000,000)	-

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Example Pass Through Entity Tax Disclosures

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Income Taxes

The Company elected to be taxed as an S Corporation for federal and state income tax purposes and, therefore, is not taxed as a separate entity. As such, the Company's taxable income or loss is included in the stockholders' individual income tax return. Therefore, no provision for income taxes related to the Company's income is included in the financial statements.

The Company's income tax returns are subject to review and examination by Federal and state authorities. The tax returns for the years 2008 to 2010 are open to examination by Federal and state authorities.

The Company recognizes income from long-term construction contracts on the percentage-of-completion method for financial statement purposes and on the completed contract method for tax reporting purposes. The Company's S Corporation income tax return depreciates property and equipment using accelerated lives and methods of depreciation. The depreciation, certain leasehold improvements, and differences in the recognition of profit on uncompleted contract are allowed as expenses and income in different years. The cumulative amounts of these differences between tax and financial statement methods of accounting are summarized as follows as of December 31, 2010 and 2009:

	2010	2009
Retained Earnings, Accompanying Financial Statements	$ 500,000	$ 400,000
Allowance for Doubtful Accounts	50,000	60,000
Difference Between Book and Tax Gross Profit Recognition	(250,000)	(200,000)
Net Fixed Asset Value Difference for Tax Purposes	(70,000)	(65,000)
Tax Return Accumulated Retained Income (Loss)	$ 230,000	$ 195,000

The anticipated shareholder Federal tax liability on deferred items at December 31, 2010 and 2009 was $95,000 and $70,000, respectively. It is expected that a distribution of $100,000 will be made in 2011 to provide the shareholder funds needed for his 2010 individual income tax liability.

Example Pass Through Entity Book Tax Treatment

24	Retained earnings	Statement 19	259,629.		253,435.
25	Adjustments to shareholders' equity (att. stmt.)				
26	Less cost of treasury stock		( )		( )
27	Total liabilities and shareholders' equity		1,373,810.		1,269,952.

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note: Schedule M-3 required instead of Schedule M-1 if total assets are $10 million or more - see instructions

1 Net income (loss) per books	131,791.	5 Income recorded on books this year not included on Schedule K, lines 1 through 10 (itemize):	
2 Income included on Schedule K, lines 1, 2, 3c, 4, 5a, 6, 7, 8a, 9, and 10, not recorded on books this year (itemize):		a Tax-exempt interest $	
Stmt 15	379,245.	Stmt 17 34,075.	34,075.
3 Expenses recorded on books this year not included on Schedule K, lines 1 through 12 and 14l (itemize):		6 Deductions included on Schedule K, lines 1 through 12 and 14l, not charged against book income this year (itemize):	
a Depreciation $		a Depreciation $ 52,724.	
b Travel and entertainment $ 24,504.		Stmt 18 13,000.	65,724.
Stmt 16 1,000.	25,504.	7 Add lines 5 and 6	99,799.
4 Add lines 1 through 3	536,540.	8 Income (loss) (Schedule K, line 18). Line 4 less line 7	436,741.

Schedule M-2 Analysis of Accumulated Adjustments Account, Other Adjustments Account, and Shareholders' Undistributed Taxable Income Previously Taxed (see instructions)

		(a) Accumulated adjustments account	(b) Other adjustments account	(c) Shareholders' undistributed taxable income previously taxed
1	Balance at beginning of tax year	-121,955.		
2	Ordinary income from page 1, line 21	512,528.		
3	Other additions Statement 10	4,659.		
4	Loss from page 1, line 21	( )		
5	Other reductions Statement 11	(104,950.)	( )	
6	Combine lines 1 through 5	290,282.		
7	Distributions other than dividend distributions	137,985.		
8	Balance at end of tax year. Subtract line 7 from line 6	152,297.		

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Example Pass Through Entity Book Tax Treatment

Schedules M-2/L — Reconciliation of Ending Schedule M-2 and Retained Earnings — Statement 20

Description	AAA	OAA	SUTIPT	Other Adjustments
Sch. M-2 balances	152,297.			
Allowance For Doubtful Accounts				-1,000.
Completed Contract Book Tax Difference				34,075.
Net Fixed Asset Book Tax Difference				68,063.
Subtotals	152,297.			101,138.
Total reconciled Schedule M-2 balances				253,435.
Ending retained earnings from Schedule L, line 24				253,435.

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Example Accounts Receivable Disclosure

NOTE 2 CONTRACT ACCOUNTS RECEIVABLE AND CONTRACT CONCENTRATIONS

Contract accounts receivable consist of the following as of December 31:

	2010	2009
Completed Contracts	$ 1,810,000	$ 1,410,000
Contracts in Progress	1,135,000	860,000
Retained on Completed Contracts	215,000	140,000
Retained on Contracts in Progress	165,000	120,000
	3,325,000	2,530,000
Less: Allowance for Uncollectible Accounts	100,000	30,000
Total, Net	$ 3,225,000	$ 2,500,000

Contract revenues from two contracts in 2010 and one different contract in 2009, in Desoto County, Florida, represented approximately 25% and 24%, respectively, of total contract revenues for the years ended December 31, 2010 and 2009, respectively. No other contracts represented greater than 10% of the total contract revenues in 2010 and 2009. The contract accounts receivable from these contracts were $1,166,000 and $800,000 as of December 31, 2010 and 2009, respectively.

Accounts Receivable Ageing At December 31, 2010					
	0 to 30	31 to 60	61 to 90	Retained	Total
Completed Contracts	$ 1,685,000	$ 50,000	$ 75,000	$ 215,000	$ 2,025,000
Contracts In Progress	1,100,000	10,000	25,000	165,000	1,300,000
	$ 2,785,000	$ 60,000	$ 100,000	$ 380,000	$ 3,325,000

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Example Backlog Note

NOTE 5 BACKLOG

The Company's backlog on signed contracts as of December 31, 2010 and 2009 is as follows:

	2010	2009
Contract Revenues:		
Backlog Balance, Beginning of Year	$ 4,500,000	$ 2,000,000
New Contracts and Contract Adjustments	21,200,000	15,000,000
Contract Revenue Earned	(18,500,000)	(12,500,000)
Backlog Balance, End of Year	$ 7,200,000	$ 4,500,000
Contract Costs:		
Backlog Balance, Beginning of Year	$ 3,980,000	$ 1,720,000
New Contracts and Contract Adjustments	18,770,885	13,310,000
Contract Costs Incurred	(16,280,000)	(11,050,000)
Backlog Balance, End of Year	$ 6,470,885	$ 3,980,000

The Company has additional contract revenue backlog of $93,000 with associated costs of $65,000 on one contract signed and contract revenue backlog of $8,600,000 with associated costs of $7,480,000 on one contract awarded, but not signed, during the period January 1, 2011 through March 4, 2011.

As of December 31, 2010 and 2009, contract costs of approximately $655,000 and $850,000 included in the above cost backlog are for subcontractors.

Example Notes Payable Disclosure

NOTE 7 **NOTE PAYABLE - BANK**

The Company has a bank line of credit available through May 1, 2011 for maximum working capital borrowings of $2,000,000. The borrowings are secured by inventories, accounts receivable, general intangibles and property and equipment. The interest rate is 1.0% over prime. The Company's stockholders have personally guaranteed the borrowings. The line of credit agreement contains covenants related to certain financial ratios.

Payable to:	Security	2010	2009
$2,000,000 renewable line of credit to Bank. Monthly installements of interest only at LIBOR plus 1.5% (which was 6.3% at December 31, 2010). Includes various financial covenants which were in compliance at December 31, 2010. Renews 5/2011.	Accounts Receivable, Inventory, Property and Equipment	$ 766,000	$ 1,085,000
Note Payable to Financial Institution, Monthly Installments of $586, Including Principal and Interest at 6.25%, Matures 3/2013	Certain Equipment	414,000	135,000
Total		1,180,000	1,220,000
Less: Current Maturities of Long-Term Debt		(773,000)	(917,000)
Long-Term Debt, Net of Current Maturities		$ 407,000	$ 303,000

The shareholders have personally guaranteed the above borrowings.

Maturity requirements on long-term debt as of December 31, 2010 are as follows:

Year Ending December 31,	Amount
2011	$ 783,000
2012	407,000

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Example Contract Notes

NOTE 8 **CONTRACTS IN PROGRESS**

The XXX open job had costs and estimated earnings in excess of billings at December 31, 2010 resulting from an approved change order of approximately $750,000 that was included in the contract price of the job but was not billed until after the 2010 year end. The approved change order was the return by the school district of some of the direct material purchase allowance deducted from the contract for that job. There are additional change orders requested by the Company on that job totaling approximately $350,000 that are in dispute. The disputed change orders are not included in the job's revenues, billings or contract price at December 31, 2010. Cost to date and total estimated cost for that job include the cost of the work performed for both the approved and unapproved change orders.

NOTE 9 **SIGNIFICANT REVISION IN CONTRACT ESTIMATE**

Revisions in estimated contract profits are made in the year in which circumstances requiring the revision become known. During 2010, a design flaw was discovered in the XXX School job being built by the Company. Management estimates that correction of the design flaw will reduce the contract's gross profit by $500,000. This change in estimate reduced 2010 net income by $150,000. No other contracts were affected by the design flaw, and the Company expects to complete the school during 2011.

Example Contingency Note

NOTE 10 **COMMITMENTS AND CONTINGENCIES**

The Company maintains and pays certain of its insurance under retrospective insurance policies. As of December 31, 2010, the Company has an outstanding irrevocable letter of credit expiring December 31, 2011, of $500,000 issued in favor of the Company's workers compensation insurance carrier.

The Company is a defendant on claims relating to matters arising in the ordinary course of their construction business. Certain of the claims are insured but subject to varying deductibles and certain of the claims are uninsured. The amount of liability, if any, from the claims cannot be determined with certainty, however, management is of the opinion that the outcome of the claims will not have a material adverse impact on the Company’s financial position.

A claim for $180,000 has been filed against the Company and its bonding company arising out of the failure of a subcontractor of the Company to pay its suppliers. In the opinion of counsel and management, the outcome of this claim will not have a material effect on the Company's financial position, results of operations or cash flows.

The Company has commitments for purchases of equipment at December 31, 2010 of $120,000.

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Example Management Continuity and Related Party Notes

NOTE 11 **STOCKHOLDER NOTES PAYABLE**

The Company had a note payable to a Shareholder in the amount of $450,000 at December 31, 2010. The note is unsecured and bears interest at the prime rate (which was 5.3% at December 31, 2010). The stockholder has subordinated repayment on the note to the outstanding surety bond obligations issued on the Company's behalf by The Travelers Companies, Inc.

NOTE 12 **BUY-SELL AGREEMENT**

The stockholders and the Company have a buy-sell agreement. In the event of a stockholder's death, the Company has the option to redeem the applicable shares of common stock at a price determined under the terms of the agreement. The Company carries $1,000,000 of life insurance on each stockholder to partially or completely fund this agreement. Any remaining balance is to be paid in five equal annual installments with interest at 8%.

NOTE 13 **RELATED PARTY TRANSACTIONS**

The Company has made advances to officers of $20,000 and $50,000 in 2010 and 2009, respectively. These advances are unsecured and bear interest at prime. Interest income was $5,000 and $4,000 for the years 2010 and 2009, respectively.

Other Example Notes

NOTE 14 **OPERATING LEASE AGREEMENTS**

The Company leases office facilities from a shareholder under a noncancelable operating lease. The lease is for five years with an option to renew under the same terms for an additional five years. Total rent expense under this operating lease was $36,000 for 2010 and 2009. Future minimum rent commitments under this facility lease are as follows:

Year Ending December 31,	Amount
2011	$ 36,000
2012	36,000
2013	6,000
Total	$ 78,000

NOTE 15 **MANAGEMENT'S PLAN FOR REORGANIZATION**

Subsequent to year end, Management developed a plan to recapitalize the Company. The Company implemented its plan by reducing payroll through staff eliminations and pay reductions, putting new procedures in place to better control change orders, and through an infusion of paid in capital in the amount of $300,000 from the existing shareholders. Additional significant contracts for new work have been signed since year end (see Note 5).

"Best of Class" Contractor Benchmarks

- Cash greater than 5% of annual revenue
- Line of credit greater then 5% of annual revenue
- Adjusted working capital at least 7.5% of revenue
  - Current assets adjusted by 50% of inventories, old receivables, under billings, related party receivables
- Adjusted equity greater than 10% of annual revenue
- No net under billings
- Overbillings at least 2% of annual revenue
- Total liabilities to equity less than 3 to 1
- Low fixed overhead (3% to 5% but percentages vary by type of contractor)

Risk Analysis and Cost to Complete

- The highest risk area in contractor financial statements is the estimate of cost to complete jobs
- Fade Gain Analysis is the primary tool used to evaluate a Contractor's ability to estimate cost to complete
  - Review significant fades or gains
  - Stratify by job type, project manager
- Review budget to actual cost comparison by cost code
- Higher risk red flags
  - Jobs 25% to 90% complete
  - Any under billed job
  - Significant self performed (not subcontracted) work

Responses

- Audit and review procedures for higher risk jobs
  - Subsequent job cost review
    - ◊ Do under billings reverse in subsequent months?
    - ◊ Do subsequent costs exceed year end cost to complete?
  - Review AIA billing documents
  - Review contracts with owners and significant subcontracts
  - Project manager interviews
- Audit procedures for higher risk jobs
  - Confirmations of contract price, change orders, billings, owner's estimate of percent complete
  - Audit sampling of cost of all jobs looking for potential cost shifting

Example Fade Gain Analysis

"CLIENTNAME"

(FADE) / GAIN ANALYSIS

December 31, 2011

Purpose: This document is used to analysis fade/gain on jobs open in the PY.
This document is also used to analyze gross profit on Jobs.

Conclusion: Explanations appear reasonable.
Based on historial completed job GP the CY GP by job appears reasonable
CY Open jobs have a open job GP of 24%, which is reasonable based on historical GP%s below.

	Contracts In Progress At 12/31/10								Contracts At 12/31/11						
Contract	Total Estimated Contract	Total Estimated Cost	Estimated Gross Profit	Gross Profit %	Revenues Earned	Cost of Revenues	Percent Complete At 12/31/10	Gross Profit	Contract Price	Total Cost	Gross Profit	Gross Profit %	Correct Revenue At 12/31/10	Fade (Under) / Gain	Change In Gross Profit %
Jobs Open PY - Closed CY.															
Job 1	418,895	210,042	208,853	49.86	343,531	172,253	82.0%	171,278	418,895	184,471	234,424	55.96	391,150	47,619	6.10
Job 2	161,291	121,948	39,343	24.39	104,217	78,796	64.6%	25,421	161,291	87,346	73,945	45.85	145,503	41,286	21.45
Job 3	976,108	631,636	344,472	35.29	681,141	440,764	69.8%	240,377	966,916	459,225	507,691	52.51	928,046	246,905	17.22
Job 4	872,171	791,565	80,606	9.24	641,182	581,924	73.5%	59,258	868,505	582,108	286,397	32.98	868,230	227,048	23.73
	$ 2,428,465	$ 1,755,191	$ 673,274	27.72	$ 1,770,071	$ 1,273,737		$ 496,334	$ 2,415,607	$ 1,313,150	$ 1,102,457	45.64	$ 2,332,929	$ 562,858	17.91
Jobs Open PY - Open CY.															
	$ -	$ -	$ -	#DIV/0!	$ -	$ -	#DIV/0!	$ -	$ -	$ -	$ -	#DIV/0!	$ -	$ -	#DIV/0!
	-	-	-	#DIV/0!	-	-	#DIV/0!	-	-	-	-	#DIV/0!	-	-	#DIV/0!
	$ -	$ -	$ -	#DIV/0!	$ -	$ -		$ -	$ -	$ -	$ -	#DIV/0!	$ -	$ -	#DIV/0!
	$ 2,428,465	$ 1,755,191	$ 673,274	27.72	$ 1,770,071	$ 1,273,737		$ 496,334	$ 2,415,607	$ 1,313,150	$ 1,102,457	45.64	$ 2,332,929	$ 562,858	17.91

Historical Comparison	Fade (Under) / Gain	Change In Gross Profit %
December 31, 2011	562,858	17.9%
December 31, 2010	552,597	12.2%
December 31, 2009	33,410	-2.9%
December 31, 2008	(44,234)	-2.6%
December 31, 2007	(83,908)	-16.5%

2011 Completed Job GP	38%
2010 Completed Job GP	22%
2009 Completed Job GP	46%
2008 Complete Job GP	14%
2007 Complete Job GP	4%

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Example Audit Risk Assessment

CLIENT NAME - CON - CX-7.1.1 Contract Risk Assessment Summary Form - December 31, 2011

NOTE: CY Costs are as of Interim Fieldwork (11/30/2010)

Contract Materiality 38,000

Contract Risk Score:
2 points if contract is over contract materiality
2 points if contract is between 25% and 90% complete.
Contracts that meet both of the criteria above are considered high risk.
Extended procedures are completed on high risk jobs which are detailed out in column N.

Contract Name / # or Group of Contracts	Risk Assessment: Significant Risks Affecting the Contract	Risk Assessment: Mitigating Factors or Controls	Risk Assessment: CY Contract Costs	Risk Assessment: POC	Risk Assessment: Risk Score	Risk Assessment: Contract Risk Score (H,M,L)	Response: Audit Approach {A}: Limited	Response: Audit Approach {A}: Basic	Response: Audit Approach {A}: Extended	Response: Comments
Job 1	Cost shifting; overly conservative or aggressive estimates		343,375	19%	2	H			X	We will mail confirmations on these contracts and perform alternative procedures on non-replies. We will test direct costs including direct labor costs for potential cost shifting. We will perform project manager interviews and obtain explanations for under/over billings and profit/fade. In addition, we will test costs to complete including review of costs incurred subsequent to year end.
All other jobs	Potential trailing costs	All other jobs are considered complete with the exception of Skyway which is open with no billings at year end and immaterial costs.			0	L		X		We will review costs incurred on jobs subsequent to year end. We will review results of profit/fade analysis.

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Data Extraction Software Audit Procedures

- Journal entry testing
  - Job cost transfer testing
  - Review activity by day of the week
  - Review journal entry activity by employee
- Comparing vendor and employee addresses for matching
- Vendor master file changes
- Stratifying Top Subcontractors or Vendors by Project Manager or Purchasing Agent for Management to review for possible “under the table” arrangements
- Identifying checks just below threshold for two signatures

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Contractor Tax Methods

- What is a Long Term Contract?
- Contractors have more than one tax method
  - Overall Method – Cash, Accrual, Accrual Without Retention
  - Exempt Contract Method – Home Construction Projects
  - Residential Contract Method – 5 or More Dwelling Units
  - All Other Contracts

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Long Term Contract Methods

- Percent Complete Method (PCM) required for contractors with revenues > $10 million on non-housing contracts
- Completed Contract Method is allowed for 1) all home, 2) 30% of residential (5+ units), and 3) all contracts by small contractors (<$10 million revenue)
- Cash and Accrual and Accrual Without Retention also allowed for contractors < $10 million
- 10% method allows deferral of income on new contracts
- AMT requires PCM for non-homes, add-back required

Example Tax Return Disclosure

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Footnotes Statement 7
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Page 2, Schedule B, Item 1
Taxpayer's Method of Accounting

Taxpayer's Overall (Non Long Term Contract)
Method of Accounting is Accrual Without
Retention under Rev. Rul. 69-314, 1969-1 C.B.
319.

Taxpayer's Exempt Long-Term Contract Method is
The Completed Contract Method.
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Domestic Production Deduction

- Production Deduction (Sec 199)
  - A deduction based on 9% of qualified productive activity income (QPAI)
    - ◊ Includes construction, architecture, engineering on U.S. real property, fabrication, mining, land improvements
    - ◊ Excludes repairs, contract mgmt, materials, hauling
    - ◊ 3 methods (simplified small bus, simplified deduction, 861)
    - ◊ Wages must be present
    - ◊ Requires K-1 disclosure on all pass-through returns

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Contractor Internal Budgeting

- Three Key Variables Determine Profitability
  - Gross Profit from job backlog
  - Timing of work completion
  - Overhead

Example Contractor Budget

SAMPLE CONSTRUCTION CONTRACTING, LLC
Statement of Forecasted Operations
For The Year Ending December 31, 2012

Forecasted 1st Through 4th Quarters

As of October 25, 2011

	Forecasted 1st Qtr	Forcasted 2nd Qtr	Forecasted 3rd Qtr	Forecasted 4th Qtr	2012 Total
Revenues from construction contracts	$ 920,500	$ 978,000	$ 698,500	$ 627,750	$ 3,224,750
Cost of revenues	857,500	906,750	643,750	576,250	2,984,250
Gross Profit	63,000	71,250	54,750	51,500	240,500
Operating expenses					
Advertising	1,500	1,500	1,500	1,500	6,000
Bank Charges	340	340	340	340	1,360
Bidding Expense	1,689	1,689	1,689	1,689	6,756
Depreciation and Amortization	1,151	1,151	1,151	1,151	4,604
Dues and Subscriptions	1,475	1,475	1,475	1,475	5,900
Employee/Client Relations	333	333	333	333	1,332
Legal and Accounting	3,642	3,642	3,642	3,642	14,568
Miscellaneous	589	589	589	589	2,356
Office Expense	8,863	8,863	8,863	8,863	35,452
Rent	2,058	2,058	2,058	2,058	8,232
Salaries	25,000	25,000	25,000	25,000	100,000
Taxes and Licenses	-	-	-	-	-
Telephone	1,727	1,727	1,727	1,727	6,908

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Revenue and Gross Profit Based on Backlog

SAMPLE CONSTRUCTION CONTRACTING, LLC								
Schedule I - Forecasted Job Completion								
As of October 25, 2011								
Job Number	Job Name	Contract Amt	Estimated Cost	Gross Profit	GP %	4th Qtr	1st Qtr	2nd Qtr
						2011	2012	2012
2011-001	Sample Job 1	800,000	735,000	65,000	8.1%	70%	90%	100%
2011-002	Sample Job 2	1,000,000	950,000	50,000	5.0%	40%	75%	100%
2011-003	Sample Job 3	2,400,000	2,200,000	200,000	8.3%	10%	25%	50%
2011-004	Sample Job 4	135,000	130,000	5,000	3.7%	50%	60%	75%
2011-005	Sample Job 5	185,000	175,000	10,000	5.4%	15%	35%	50%
		-	-	-	#DIV/0!	0%	0%	0%
				-	#DIV/0!	0%	0%	0%
		-	-	-				
	Total	$ 4,520,000	$ 4,190,000	$ 330,000				

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