The financial statements of a business entity are prepared and governed by the guidance and application of generally accepted accounting principles (GAAP). GAAP is the term used to refer to a standard framework of guidelines for financial accounting. GAAP includes the standards, conventions, and rules accountants follow in recording and summarizing transactions and in preparing financial statements. Even within GAAP, there can be some different presentations of financial data, since financial statements reflect information for different types of companies; however, all financial statements must adhere to certain overall concepts and principles. Some GAAP requirements are formal and specific, while others are guidance, based more in tradition or history, or more general concepts and principles. In all cases, the goal is to make financial statements usable to the third-party reader. Such standards are important to the efficient functioning of the economy, as investors, creditors, auditors, and others rely on credible, transparent, and comparable financial information as part of their various evaluations of the financial data presented by a business entity.

Although there are a number of organizations and publications that issue or contain guidelines, there is no single source or manual one can refer to when determining GAAP. As can be seen below, GAAP stems from numerous sources, depending on the individual issue or application.

Financial Accounting Standards Board

Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector for establishing standards for financial accounting. Those standards govern the preparation of financial statements. They are officially recognized as authoritative by the Securities

The mission of the FASB is to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information. The FASB develops broad accounting concepts as well as standards for financial reporting. It also provides guidance on implementation of standards.

On June 30, 2009, the FASB issued FASB Statement No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162. On the effective date of this standard, the FASB Accounting Standards Codification (ASC) became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. The ASC significantly changes the way financial statement preparers, auditors, and academics perform accounting research, and are effective for financial statements issued for interim and annual periods ending after September 15, 2009.

This new standard flattens the GAAP hierarchy to two levels: one that is authoritative (what is in the FASB ASC) and one that is nonauthoritative (items not found in the FASB ASC). Exceptions to this two-level hierarchy include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative GAAP for SEC registrants, but may not be included in the FASB ASC.

The FASB ASC is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative GAAP by providing the authoritative literature in a topically organized structure. The FASB ASC disassembles and reassembles thousands of nongovernmental accounting pronouncements to organize them under approximately 90 topics and include all accounting standards issued by a standard letter. FASB ASC also includes relevant portions of authoritative content issued by the SEC, as well as selected SEC staff interpretations and administrative guidance issued by the SEC. However, as mentioned, FASB ASC is not the official source of SEC guidance and does not contain the entire universe of SEC rules, regulations, interpretive releases, and staff guidance. Moreover, the FASB ASC does not include governmental accounting standards, and is not intended to change GAAP or any requirements of the SEC.

In addition to the specific guidance in the various FASB promulgations, financial statements are subject to overall guidance and principles, known as the “Fundamental Principles”:

- **Realization.** Under this basic principle, economic events are accounted for only when the business has been a party to one side of a bona fide transaction. For example, if a parcel of land has appreciated in value, the gain cannot be recognized until the land has been sold. See FASB Statement of Financial Accounting Concepts (SFAC) No. 5.
• *Conservatism.* This principle directs that when a business is exposed to uncertainties and risks that are material, measurement and disclosure should be approached with a high degree of caution and in a prudent manner, until evidence develops that there is a significant reduction or elimination of the uncertainty. *See FASB SFAC No. 2.*

• *Revenue recognition.* This principle states that revenue is recognized when everything that is necessary to earn the revenue has been completed. *See FASB SFAC No. 5.*

• *Matching.* This requires that the revenues of any accounting period be matched with the expenses of that same period that were incurred to generate the revenues. *See FASB SFAC No. 6.*

• *Separate entity assumption.* This principle provides that the business is an entity that is separate and distinct from its owners. Accordingly, the finances of the firm are not to be commingled with the finances of the owners. *See FASB SFAC No. 6.*

• *Full disclosure.* This mandates that all of the information about the business entity that is needed by the users of its financial statements be disclosed in understandable form.

• *Consistency.* This requires that the accounting procedures applied during a given accounting period be the same procedures that were applied in previous periods, unless any changes are within generally accepted accounting principles and are properly disclosed to the users. *See FASB SFAC No. 2.*

• *Going concern.* The principle of “going concern” assumes that an entity will continue to operate in the near future, which is generally understood to mean more than the next 12 months, so long as it generates or obtains sufficient resources to operate.

**American Institute of Certified Public Accountants**

The American Institute of Certified Public Accountants (AICPA) is the national, professional organization for all certified public accountants in the United States. Its stated mission is to provide its members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public, as well as their employers and clients. Although individual CPAs are licensed by the individual states, the governing body for CPA exams and standards is the AICPA. Although each state can have its own requirements for licensing, the AICPA’s Uniform CPA Exam is a nationally standard test. The AICPA sets professional standards for CPAs and monitors and enforces those standards.

Part of the AICPA is its Accounting Standards Team. The objectives of the Accounting Standards Team are

• To develop industry-specific guidance regarding financial accounting and reporting matters. As an example, there is specific guidance developed for GAAP application in the construction industry, set forth in an Industry Guide published by the AICPA.
• To provide guidance to members of the AICPA on financial accounting or reporting issues not otherwise covered in authoritative literature.
• To influence the form and content of pronouncements of the FASB, the Governmental Accounting Standards Board (GASB), International Accounting Standards Board (IASB), and other bodies that have authority over financial accounting or reporting standards.

**Standards Other than GAAP**

There are some situations where the normal application of GAAP does not apply. The alternative standards that may apply in such situations are referred to as Other Comprehensive Bases of Accounting (OCBOA). OCBOA includes income-tax basis and the cash basis of accounting that is commonly used for smaller or less sophisticated entities. OCBOA usually refers to

• A statutory basis of accounting (for example, a basis of accounting that insurance companies are required to use under the rules of a state insurance commission);
• Income-tax-basis financial statements;
• Cash-basis and modified-cash-basis financial statements; and
• Financial statements prepared using definitive criteria having substantial support in accounting literature that the preparer applies to all material items appearing in the statements (such as the price-level basis of accounting).

In situations where GAAP-basis financial statements are not necessary because of the lack of any loan covenants, regulatory requirements, or similar circumstances applicable to the entity preparing the financial statements, an OCBOA-based statement may be used. In the construction industry, the nature of construction projects and the complexities surrounding issues such as estimates to complete and matching of revenue make the use of OCBOA virtually nonexistent, except perhaps for the smallest of contractors.

**Auditing Standards**

AICPA members who perform auditing and other related professional services are required to comply with Statements on Auditing Standards (SASs) promulgated by the AICPA Auditing Standards Board (ASB). These standards constitute what are known as generally accepted auditing standards (GAAS). In the past, the ASB's auditing standards have applied to audits of all entities. As a result of the Sarbanes-Oxley Act of 2002, however, auditing and related professional practice standards to be used in the performance and reporting on audits of the financial statements of public companies are now established by the Public Company Accounting Oversight Board (PCAOB). Audits of nonpublic companies remain governed by GAAS as issued by the ASB.
Public accounting firms registered with the PCAOB are required to adhere to all PCAOB standards in the audits of “issuers,” a term defined by the Sarbanes-Oxley Act, and other entities when prescribed by the rules of the SEC (collectively referred to here as “issuers”). Those entities not subject to the Sarbanes-Oxley Act or the rules of the SEC (“nonissuers”) must conduct their preparation and issuance of audit reports in accordance with standards promulgated by the ASB.

**Generally Accepted Auditing Standards**

GAAS consists of 10 auditing standards: three general standards, three standards for field work, and four standards of reporting, along with interpretations. They were developed by the AICPA in 1947 and have undergone minor changes since then.

**General Standards**

1. The auditor must have adequate technical training and proficiency to perform the audit.
2. The auditor must maintain independence in mental attitude in all matters related to the audit.
3. The auditor must use due professional care during the performance of the audit and the preparation of the report.

**Standards of Field Work**

1. The auditor must adequately plan the work and must properly supervise any assistants.
2. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal controls, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.
3. The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

**Standards of Reporting**

1. The auditor must state in the auditor’s report whether the financial statements are in accordance with GAAP.
2. The auditor must identify in the auditor’s report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor’s report.
4. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that such an opinion cannot be expressed in the auditor’s report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor’s report. In all cases where the auditor’s name is associated with the financial statements, the auditor should clearly indicate the character of the auditor’s work, if any, and the degree of responsibility the auditor is taking in the auditor’s report.

Types of Audits

The use of the term “audit” is often used by non-accounting professionals to refer generally to a number of different services performed by accountants and expectations on the part of their clients. To the accounting profession, however, the term “audit” has a much more precise definition. In fact, there are a number of different types of audits, and the following is a description of the services provided and intended uses of such different types of audits.

Financial Statement Audit

A financial audit, or more accurately, an audit of financial statements, is the application of testing and other procedures relating to the financial statements of a company or other legal entity (including governments), resulting in the publication of an independent opinion on whether or not those financial statements present fairly, in all material respects, the financial position and the results of operations and cash flow of a company. Financial statement audits are typically performed by independent CPA firms, due to the specialized financial reporting knowledge required to perform these audits. The financial audit is one of many assurance or attestation functions provided by accounting firms, whereby the firm provides an independent opinion based on published information. Only by having an audit performed by an independent firm of certified public accountants can one be assured that the entity performing the audit is held accountable to all of the rules and regulations described above. Many organizations separately employ or engage internal auditors, who do not attest to financial reports but focus mainly on the internal controls of the organization. External auditors may choose to place limited reliance on the work of internal auditors.

The financial statement audit is designed to reduce the possibility of a material misstatement. A misstatement is defined as false or missing information, whether caused by fraud (including deliberate misstatement) or error. “Material” is very broadly defined as something large enough or important enough to cause third parties (e.g., stockholders, banks, sureties) to alter their decisions. The assessment of what is material is a matter of professional judgment. Auditors can obtain guidance regarding the conduct of financial statement audits from Auditing Standards No. 107, Audit Risk and Materiality in Conducting an Audit.
Fraud Audit

A fraud audit is a customized set of procedures and tests specifically designed to investigate the suspicion of fraudulent activity. Unlike a financial statement audit, which is designed to assure readers that the financial statements presented are free of material misstatements, a fraud audit is designed to uncover specific fraudulent activity and to identify the fraudster or perpetrator of the fraud. Fraud audits are commonly performed by CPAs specializing in forensic accounting.

Internal Audit

A company that wishes to measure compliance with its internal policies and procedures may perform an internal audit. Internal auditors are not responsible for the execution of company activities; instead, they advise management and the board of directors (or similar oversight body) as to how to better execute their responsibilities. In view of their broad scope of involvement in reviewing the business activities of the company, internal auditors often have a variety of higher educational and professional backgrounds. Internal auditors sometimes report directly to the audit committee of the company’s board of directors.

Internal auditing activity is primarily directed at evaluating and improving the company’s internal controls. An internal control is broadly defined as a process, put into effect by an entity’s board of directors, management, and other personnel, that is designed to provide reasonable assurance regarding the achievement of objectives in the following internal control categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with laws and regulations

Management is responsible for the internal controls of the entity. Managers establish policies and processes to help the organization achieve specific objectives in each of these categories. Internal auditors then perform audits to (1) evaluate whether those policies and processes are designed and operating effectively, and (2) provide recommendations for improvement.

Based on a risk assessment of the organization, a combination of the internal auditors, management, and oversight boards generally determines where to focus internal auditing efforts. Internal auditing activity is generally conducted as one or more discrete projects.

Government Audit

The generally accepted government auditing standards (GAGAS), commonly referred to as the “Yellow Book,” are produced in the United States by the Government Accountability Office (GAO).
The GAGAS apply to both financial and performance audits of government agencies. Five general standards are included:

- Independence
- Due Care
- Continuing Professional Education
- Supervision
- Quality Control

The Yellow Book includes standards to guide all audits of governmental units, without regard to the level of the unit. The standards are considered broad statements of auditors’ responsibilities. The introduction to the Yellow Book states its purpose as providing “standards for audits of government organizations, programs, activities, and functions, and of government assistance received by contractors, nonprofit organizations, and other nongovernment organizations.”

Government audits are often a combination of financial and performance audits. For example, auditors conduct audits of government contracts and grants with private-sector organizations, as well as of government and not-for-profit organizations where both financial and performance objectives must be audited. Performance audit objectives vary widely and include assessments of program effectiveness, economy efficiency, internal controls, compliance, and prospective analysis.

The GAGAS are classified as general, field, or reporting standards. The GAGAS incorporate the generally accepted auditing standards as promulgated by the Auditing Standards Board of the AICPA. However, there are some additional standards that relate to the accountability of government units for compliance with laws and regulations. There are also more extensive reporting requirements related to such accountability.

**Contract or Project Audit**

“Project audit” is a common term in the construction industry but has no specific meaning in the accounting profession. In a general sense it refers to a review of the accumulated costs on a given construction project. The services generally included are a review of the specific costs for labor, materials, equipment, and subcontractors on the project as measured against a given standard such as the contract, sales tax laws, Federal Acquisition Regulations (FAR), a joint venture agreement, or similar standard. When initiating a project audit, careful consideration should be given to the requested services, the standards to be applied, and the use of the information once complete.

**Operational Audit**

An operational audit is an evaluation made of management’s performance and its conformity with policies, procedures, and budgets. The organization
and its operations are analyzed, including the structure, controls, procedures, and processes. The objective is to assess the effectiveness and efficiency of a division, activity, or operation of the entity in meeting company goals. Recommendations to improve performance are also made. The primary user of operational audits is the firm’s management. Operational audits can be performed by either external auditors or internal auditors. For each review, management receives a report that indicates how well the activities are performed and procedures are followed, suggests improvements, and provides conclusions from the work performed.

Basic Financial Statements

The term “financial statements” has varied meanings depending upon the circumstances of their creation and the level of information to be provided. The two most basic financial statements are the income statement and balance sheet. But a full set of financial statements in the construction industry would commonly include an income statement, balance sheet, cash flow statement, notes to the financial statements, and the auditors’ opinion. Commonly, although they are not required, construction industry financial statements also include supplementary statements, which typically include a detailed statement of earnings by contract and a detail of general and administrative costs. As such, a request for “financial statements” needs to specify the individual statements requested. It is the review of these various statements and their comparison with similar statements for prior years that enables a knowledgeable reader to gain insight into the successes and challenges of a given construction-business entity.

It should be noted further that there are occasionally different titles used for these basic components of financial statements and certain variations in the data presented. This can be entirely acceptable so long as they are consistent from one year to the next. The following discussion uses the most common titles, and the concepts in any event remain similar from one company to the next.

Balance Sheet

The balance sheet is a statement of what the company (or other business entity) owns (its assets) and owes (its liabilities), and the excess or deficit in comparing those two values (the owners’ equity or the company’s net worth). Unlike other financial statements that include transactions over a period of time, the balance sheet indicates amounts at a specific point in time. Typical captions and amounts shown on the balance sheet are:

- **Current Assets** includes items such as cash and cash equivalents, short-term investments, and current accounts receivable inventory that are considered cash or readily converted to cash and so likely provide immediate purchasing power.
10 CHAPTER 1: BASIC FINANCIAL AND ACCOUNTING CONCEPTS

- **Fixed Assets** includes items such as land, buildings, and equipment that are owned by the company for its use in the operations of the business.

- **Current Liabilities** includes items such as accounts payable and accrued payroll that will consume cash in the immediate future.\(^1\)

- **Long-Term Liabilities** includes items such as notes payable and other noncurrent payables that are obligations of the company, but are not expected to be paid within one year.

- **Owner’s or Shareholders’ Equity** includes items such as common stock and retained (i.e., cumulative) earnings of the company. This section of the balance sheet represents the total amount that has been invested in the company by its owners—both directly and through its earnings history.\(^2\)

Two special accounts that are important in understanding a construction company’s balance sheet are **Billings in Excess of Cost and Estimated Revenues** and **Costs and Estimated Earnings in Excess of Billings**. These accounts reflect how much a company has billed in its contracts ahead of its costs incurred (a liability, based on the premise that this excess will need to be eliminated as each contract progresses toward completion), or how much the company has incurred in costs ahead of its actual contract billings (an asset, based on the premise that billings on each contract will eventually catch up to costs incurred), respectively. These two accounts are addressed in more detail in Chapter 2.

Figure 1 is a sample balance sheet for a healthy small construction company, Example Construction.

---

**Figure 1**

**Balance Sheet for Example Construction, Inc.**

**Example Construction, Inc.**

**Balance Sheets**

**December 31, 20X1 and 20X0**

<table>
<thead>
<tr>
<th>Assets</th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Current Assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$492,700</td>
<td>$435,300</td>
</tr>
<tr>
<td>Accounts receivable (notes 1 and 3)</td>
<td>1,393,000</td>
<td>1,223,600</td>
</tr>
<tr>
<td>Costs and estimated earnings in excess of billings on uncompleted contracts (note 4)</td>
<td>732,600</td>
<td>741,800</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>89,900</td>
<td>53,900</td>
</tr>
<tr>
<td><strong>Total Current Assets</strong></td>
<td>2,708,200</td>
<td>2,454,600</td>
</tr>
<tr>
<td><strong>Fixed Assets, net.</strong></td>
<td>290,000</td>
<td>269,800</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$2,418,200</td>
<td>$2,184,800</td>
</tr>
</tbody>
</table>

---
Basic Financial Statements

11

The income statement is a report for a given accounting period (usually a fiscal year) that indicates the revenue earned by the business entity, the expenses incurred for that same period, and the resulting net income available to be distributed or retained by the company as appropriate. The income statement is generally presented in three main sections, the titles of which can vary somewhat from one company to another:

- **Revenue from Operations** represents the gross receipts of the company before any deductions for expenses. For a construction contractor, this amount is generally the amount of contract billings during the year, after adjustments for billing ahead or behind the actual progress on the firm’s various contracts that are in progress as of the end of the accounting period. The percentage-of-completion analysis for individual contracts can be complicated, as is discussed further in Chapter 3.

- **Cost of Operations** represents the direct cost of producing the Revenue from Operations. In the construction industry, this cost generally includes the labor, material, equipment, and subcontractor costs that are directly attributable to a specific contract and are incurred at the job site. Depending on the company, there are instances where companies will treat some expenses as direct project costs for financial reporting purposes (such as roving superintendents who are not assigned to any one project, certain equipment ownership administrative expenses, and particular insurance costs and related administrative expenses) that other

---

**Basic Financial Statements**

<table>
<thead>
<tr>
<th>Liabilities and Shareholders’ Equity</th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$904,900</td>
<td>$821,200</td>
</tr>
<tr>
<td>Accrued salaries and wages</td>
<td>138,300</td>
<td>155,100</td>
</tr>
<tr>
<td>Accrued and other liabilities</td>
<td>169,400</td>
<td>91,750</td>
</tr>
<tr>
<td>Billings in excess of costs and estimated earnings on</td>
<td></td>
<td></td>
</tr>
<tr>
<td>uncompleted contracts (note 4)</td>
<td>34,500</td>
<td>43,700</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td>1,247,100</td>
<td>1,111,750</td>
</tr>
<tr>
<td>Long-term debt, less current maturities (note 6)</td>
<td>245,000</td>
<td>241,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>1,492,100</td>
<td>1,352,750</td>
</tr>
<tr>
<td>Shareholder’s Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock—$10 par value, 50,000 authorized shares, 23,500 shares issued and outstanding shares</td>
<td>$235,000</td>
<td>$235,000</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>65,000</td>
<td>65,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>627,000</td>
<td>532,050</td>
</tr>
<tr>
<td>Total Shareholders’ Equity</td>
<td>$927,000</td>
<td>$832,050</td>
</tr>
<tr>
<td>Total Liabilities and Shareholders’ Equity</td>
<td>$2,419,100</td>
<td>$2,184,800</td>
</tr>
</tbody>
</table>

---

**Income Statement**

The income statement is a report for a given accounting period (usually a fiscal year) that indicates the revenue earned by the business entity, the expenses incurred for that same period, and the resulting net income available to be distributed or retained by the company as appropriate. The income statement is generally presented in three main sections, the titles of which can vary somewhat from one company to another:

- **Revenue from Operations** represents the gross receipts of the company before any deductions for expenses. For a construction contractor, this amount is generally the amount of contract billings during the year, after adjustments for billing ahead or behind the actual progress on the firm’s various contracts that are in progress as of the end of the accounting period. The percentage-of-completion analysis for individual contracts can be complicated, as is discussed further in Chapter 3.

- **Cost of Operations** represents the direct cost of producing the Revenue from Operations. In the construction industry, this cost generally includes the labor, material, equipment, and subcontractor costs that are directly attributable to a specific contract and are incurred at the job site. Depending on the company, there are instances where companies will treat some expenses as direct project costs for financial reporting purposes (such as roving superintendents who are not assigned to any one project, certain equipment ownership administrative expenses, and particular insurance costs and related administrative expenses) that other
entities may treat as general and administrative costs (G&A) and report elsewhere. As mentioned previously, the key to this reporting is consistency, maintaining the same accounting treatment from year to year, and thereby making comparative analysis and ratio calculations meaningful.

- **G&A Expenses** represents the expenses that are incurred by the company but are not reasonably assignable to a specific contract. G&A expenses are usually incurred either at the home office or at regional, divisional, or branch offices. They typically include the salaries of the company executives, as well as those of the accounting, human resources, marketing/business development, and information technology functions. These expenses are normally considered fixed—at least over a short time-frame—in that they do not increase or decrease based on the firm’s overall volume of contract revenues. Over time, they will increase, often in a step fashion, if the company’s revenues increase.

Figure 2 shows a very basic income statement for Example Construction, which illustrates that the company is growing from year to year:

---

**Figure 2**

**Income Statement for Example Construction, Inc.**

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract revenues earned</td>
<td>$9,487,000</td>
<td>$8,123,400</td>
</tr>
<tr>
<td>Cost of revenues earned</td>
<td>8,458,500</td>
<td>7,392,300</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>1,028,500</td>
<td>731,100</td>
</tr>
<tr>
<td>General and administrative expenses</td>
<td>848,300</td>
<td>643,100</td>
</tr>
<tr>
<td>Interest expenses</td>
<td>26,500</td>
<td>23,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$153,700</td>
<td>$65,000</td>
</tr>
</tbody>
</table>

**Statement of Cash Flows**

The statement of cash flows is an insightful report that demonstrates the actual sources and uses of cash by the company over the accounting period being addressed in the financial statements, and thereby indicates its liquidity and ability to meet its cash needs. This statement is required to be included in audited financial statements. The cash flow statement has four common elements:

- **Cash flows from operating activities.** This is the net income for the accounting period, adjusted by any increases or decreases in accounts
receivable and accounts payable that altered the company’s cash position. For example, if a company has earned net income on an accrual basis, but increased its accounts receivable by the same amount (meaning its billings were not being paid as promptly as in the prior period), the increase in cash flows from operations from year to year would be zero, despite the increased net income. Depreciation charged as an expense on the income statement, reducing the company’s net income to reflect the reduced value of its fixed assets as a year of their useful life had been consumed, appears on the cash flow statement as an increase in cash because this depreciation is a noncash expense.

- **Cash flows from investing activities.** This is the change in investment and fixed asset balances over the accounting period and how they affected the cash available to the company. For example, if a company sold equipment during the year, the proceeds would add to the cash available to the company, and those proceeds would show as a positive source of cash on this statement (but as a reduction in fixed assets on the balance sheet). Purchases of additional fixed assets, by contrast, appear as a negative since they consume available cash.

- **Cash flows from financing activities.** This section of the report shows the new borrowings and/or retirement of debt of the company, as well as the owner’s equity transactions. A positive subtotal for these sections indicates that the company has increased its debt; a negative amount indicates it has, on balance, reduced or retired debt or paid dividends. The payment of a dividend reduces the owner’s equity in the company and appears as a negative amount, since it consumes cash.

- **Net Increase (Decrease) in Cash.** This is the net amount of the operating, investing, and financial cash flows, and represents the actual increase or decrease in the company’s cash balances for the period.

The Statement of Cash Flows for Example Construction is shown in Figure 3.

---

**Figure 3**

**Statement of Cash Flows for Example Construction, Inc.**

**Example Construction, Inc.**

**Statement of Cash Flow**

**December 31, 20X1 and 20X0**

<table>
<thead>
<tr>
<th></th>
<th>20X1</th>
<th>20X0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flow from operating activities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td>$ 153,700</td>
<td>$ 65,000</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash provided by operating activities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>54,800</td>
<td>50,300</td>
</tr>
<tr>
<td>Decrease in billings in excess of costs on uncompleted contracts</td>
<td>(9,200)</td>
<td>(16,300)</td>
</tr>
</tbody>
</table>
(Increase) decrease in costs in excess of billings on uncompleted contracts.......................... 9,200 (49,100)
(Increase) decrease in prepaid expenses ......................... (36,000) 16,500
Increase in accounts payable ......................................... 83,700 24,600
(Decrease) increase in accrued salaries and wages ............... (153,100) 24,300
(Decrease) increase in accrued and other liabilities ............ 77,650 (39,400)
Net cash provided by operating activities .......................... $ 180,750 $ 75,900

Cash flows from investing activities:
(Purchase) sale of property and equipment ....................... (75,000) 153,915
Net cash used in investing activities ................................. $ (75,000) $ 153,915

Cash flows from financing activities:
Proceeds from issuance of long-term debt ......................... 44,000 68,000
Principal payments on long-term debt .............................. (33,600) (15,500)
Cash dividends paid .................................................... (58,750) (58,750)
Net cash used in financing activities ................................. $ (48,350) $ (6,250)

Net increase (decrease) in cash and cash equivalents .......... 57,400 223,565
Cash and cash equivalents at beginning of year .................. 435,300 211,735
Cash and cash equivalents at end of year ......................... $ 492,700 $ 435,300

Notes to Financial Statements
In general, a set of explanatory Notes to Financial Statements is required for audited financial statements. The notes are used to further explain, add clarity, or describe the various activities and balances contained within the other portions of the company’s financial statements. There is no limit to the number of notes, and they should be carefully studied, as the notes generally explain key areas that significantly assist in understanding the basic financial statements. The AICPA Audit and Accounting Guide—Construction Contractors recommends that notes covering significant accounting policies, revised estimates, backlog on existing contracts, and receivables should be included within the Notes to Financial Statements of a construction contractor. The following is a partial list of notes that are commonly seen in the audited financial statements of a construction contractor:

- **Company.** This note normally contains general information about the company, its form of organization, location, and so on.
- **Summary of Significant Accounting Policies.** This note should list the significant accounting concepts used in preparing the financial statements of the company, and detailed explanations of certain accounts. The following are topics that may be covered within this note:
  - **Basis of Presentation.** Should contain a statement concerning adherence to GAAP and any departures and rationale for the departures from GAAP.
• **Use of Estimates.** Should contain a statement acknowledging that certain balances contained in the financial statements are based on management estimates, and may significantly differ from actual results.

• **Method of Reporting Affiliated Entities.** This note should contain information about the method used to integrate the finances of affiliated entities (e.g., subsidiaries and other companies under some form of common ownership or control) into the financial statements.

• **Operating Cycle.** This note should disclose whether the timing of one operating cycle (i.e., the average length of the firm’s construction contracts) is longer than one year; if so, the range of contract durations for the contracts undertaken by the company should be disclosed.

• **Revenue Recognition.** This note should disclose whether the percentage-of-completion or the completed-contract method is used for revenue recognition purposes (covered in Chapter 2), and the types of contracts performed by the company.

• **Method of Reporting Joint Venture Investments.** This note should contain information about the method used to integrate the finances of joint ventures (one-time agreements to jointly undertake a contract with an unrelated firm) into the financial statements.

• **Contract Costs/Deferred Costs.** Should contain information concerning the values of unapproved change orders or claims that are included within the total contract costs.

• **Deferred Revenue.** If the company receives payments in advance of performing the services that will generate the revenue (such as an advance payment at the outset of a construction contract), this note would contain information as to how the company handles such advance payments for reporting purposes.

• **Income Taxes.** This note should provide an explanation of the company operations and earnings that are subject to income taxes imposed by various federal, state, and local jurisdictions. This note should detail the effect of income taxes on the financial statements.

• **Earnings per Share.** Should provide an explanation of how the values reported for earnings per share are determined.

• **Revised Estimates.** As noted above, the use of estimates is an element addressed in the Summary of Significant Accounting Policies note. However, estimates are frequently revised, and if these revised estimates affect the current or future accounting periods negatively, then the Revised Estimates note should be contained within the financial statements and noted separately in this note.

• **Backlog on Existing Contracts.** This note should discuss the future expected value of contracts that the company believes to have little chance of cancellation.

• **Receivables.** The note on this topic should discuss the source, components, and further comments, if necessary, regarding the accounts receivable of the company.
• **Acquisitions.** If applicable, this note should contain explanations of other business entities acquired or sold by the company.
• **Property and Equipment.** This note should identify the categories of the company’s fixed assets and the corresponding reported values for each category.
• **Intangible Assets.** If applicable, this note will contain information about the amounts reported pertaining to nonmonetary assets, such as intellectual property, goodwill recognized from business acquisitions, and competitive advantages.
• **Accounts Payable and Accrued Expenses.** The note on this topic should discuss the treatment of the Accounts Payable and Accrued Expenses of the company, and provide further comments on them where necessary.
• **Notes Payable.** This note should contain further details of notes payable, including identification of the current and noncurrent obligations that are within this amount.
• **Stockholder’s Equity.** This note should discuss details of any stock-related activities approved by the board of directors, such as stock splits or stock dividends.
• **Commitments and Contingencies.** This note should contain information about pending litigation, as well as any off-balance sheet arrangements.
• **Business Segment Information.** If applicable, this note should contain details as to how individual segments of the company’s business performed financially.
• **Subsequent Events.** When applicable, this note details any significant events that occurred after the date of the balance sheet that could influence any third-party user of the financial statements.

**Supplemental Schedules to Financial Statements**

Supplemental schedules to the financial statements may also be provided as part of the audited financial statements. Supplemental schedules are used to further detail the activities of the contractor on individual projects, and allow for further analysis of the company’s performance on its critical projects. Two common supplemental schedules for construction contractors are a detail of the firm’s G&A expenses and a contract-by-contract detailed schedule of revenues, costs, and gross profit.

The detail of contract revenues, costs, and gross profit can be used to review the performance of a given contract performed by the company. It contains contract-specific data from the inception of the contract to the end of the reporting period, as well as the data specific to the year being reported. Samples of these supplemental schedules are attached as Appendix A and Appendix B.

**Project Accounting and Revenue Recognition**

Two of the issues that distinguish construction company financial statements from most other businesses are that the revenue cycle (typical contract
duration) often exceeds one year, and the projected net revenue from each contract is subject to an estimate of the final cost to complete the contract. Unlike a retail company that buys and sells goods on an ongoing basis and has a relatively short revenue cycle from purchase to sale, construction contractors enter into contracts that frequently span multiple years. Further, the final profit to be recognized on any given contract is not known until the work has been completed. The established methods for contract accounting are therefore unique and are addressed in the AICPA’s Construction Contractors Audit Guide and FASB Accounting Standards Codification Topics 910 and 605, formerly prescribed in Statement of Position (SOP) 81-1. These issues unique to the construction industry are discussed in more detail in Chapter 2.

Conclusion

This chapter serves as an introduction to the complexities of financial accounting for construction contractors, reporting for internal and external purposes, and the various types of audits utilized to insure proper financial reporting. Proper financial reporting for internal purposes greatly aids management in making sound decisions. Proper financial reporting for external purposes assures investors and credit grantors (such as banks and bonding companies) that their money is being used wisely. The combination of sound reporting for both purposes is essential to the success of any company.

Notes

1. The greater the excess of current assets over current liabilities, the more “liquid” a company is. This excess is a measure of the company’s ability to handle short-term cash requirements. This comparison is generally expressed as current assets/current liabilities or the current ratio.

2. In general, the ratio of equity to the liabilities of a company is an indicator of the long-term financial strength of the firm. Bonding companies, among others, pay attention to this debt/equity ratio. These and other ratios and factors considered by bonding companies are discussed further in Chapter 3.
## APPENDIX A

### Supplemental Schedule of Contract Revenues, Costs, and Earnings

<table>
<thead>
<tr>
<th>Contract</th>
<th>Total Contract</th>
<th>From Inception to December 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Revenues</td>
</tr>
<tr>
<td>1908</td>
<td>$ 6,750,220</td>
<td>$ 877,000</td>
</tr>
<tr>
<td>2130</td>
<td>1,471,800</td>
<td>127,100</td>
</tr>
<tr>
<td>2852</td>
<td>451,800</td>
<td>(130,100)</td>
</tr>
<tr>
<td>2009</td>
<td>11,125,000</td>
<td>847,900</td>
</tr>
<tr>
<td>1985</td>
<td>3,650,100</td>
<td>497,000</td>
</tr>
<tr>
<td>Small Contracts</td>
<td>51,300</td>
<td>8,400</td>
</tr>
<tr>
<td></td>
<td><strong>$ 23,500,220</strong></td>
<td><strong>$ 2,227,300</strong></td>
</tr>
</tbody>
</table>
### Appendix A

From Inception to December 31, 20X1 | At December 31, 20X1 | For the year ended December 31, 20X1
--- | --- | ---
**Billed to Date** | **Estimated Costs to Complete** | **Costs and Estimated Earnings in Excess of Billings** | **Billings in Excess of Costs and Estimated Earnings** | **Revenues Earned** | **Cost of Revenues** | **Gross Profit (Loss)**
--- | --- | --- | --- | --- | --- | ---
$5,976,000 | $628,720 | $15,100 | $ – | $5,664,200 | $4,984,500 | $679,700
1,195,800 | 204,900 | 54,600 | – | 962,800 | 899,000 | 63,800
98,100 | 343,200 | 10,500 | – | 98,600 | 191,500 | (92,900)
7,808,000 | 3,231,600 | – | 145,700 | 6,981,900 | 6,469,900 | 512,000
2,491,500 | 1,091,800 | – | 96,300 | 2,395,200 | 2,061,300 | 333,900
49,800 | 1,200 | – | – | 39,000 | 30,700 | 8,300
--- | --- | --- | --- | --- | --- | ---
$17,619,200 | $5,501,420 | $80,200 | $242,000 | $16,141,700 | $14,636,900 | $1,504,800

**Source:** 2008 AICPA Audit and Accounting Guide—Construction Contractors, p. 220.
### Supplemental Schedule of Contracts

#### Example Construction, Inc.
**Supplemental Schedule of Contracts**
**December 31, 20X1**

<table>
<thead>
<tr>
<th>Contract Number</th>
<th>Type</th>
<th>Total Contract</th>
<th>From Inception to December 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Revenues</td>
<td>Estimated Gross Profit</td>
</tr>
<tr>
<td>1908</td>
<td>B</td>
<td>$6,750,220</td>
<td>$877,000</td>
</tr>
<tr>
<td>2130</td>
<td>A</td>
<td>1,471,800</td>
<td>127,100</td>
</tr>
<tr>
<td>2852</td>
<td>B</td>
<td>451,800</td>
<td>(130,100)</td>
</tr>
<tr>
<td>2009</td>
<td>B</td>
<td>11,125,000</td>
<td>847,900</td>
</tr>
<tr>
<td>1985</td>
<td>B</td>
<td>3,650,100</td>
<td>497,000</td>
</tr>
</tbody>
</table>

**Small Contracts**

<table>
<thead>
<tr>
<th>Total</th>
<th>Revenues</th>
<th>Estimated Gross Profit</th>
<th>Gross Profits (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$23,500,220</td>
<td>$2,227,300</td>
<td>$17,032,400</td>
<td>$15,346,500</td>
</tr>
</tbody>
</table>

**Contract Types**
- A—Fixed Price
- B—Cost-Plus-Fee
<table>
<thead>
<tr>
<th>From Inception to December 31, 20X1</th>
<th>At December 31, 20X1</th>
<th>For the year ended December 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billed to Date</td>
<td>Estimated Costs Complete</td>
<td>Costs and Estimated Earnings in Excess of Billings</td>
</tr>
<tr>
<td>-------------------------------------</td>
<td>---------------------</td>
<td>-------------------------------------------------</td>
</tr>
<tr>
<td>$ 5,976,000</td>
<td>$ 628,720</td>
<td>$ 15,100</td>
</tr>
<tr>
<td>1,195,800</td>
<td>204,900</td>
<td>54,600</td>
</tr>
<tr>
<td>98,100</td>
<td>343,200</td>
<td>10,500</td>
</tr>
<tr>
<td>7,808,000</td>
<td>3,231,600</td>
<td>–</td>
</tr>
<tr>
<td>2,491,500</td>
<td>1,091,800</td>
<td>–</td>
</tr>
<tr>
<td>49,800</td>
<td>1,200</td>
<td>–</td>
</tr>
<tr>
<td>$ 17,619,200</td>
<td>$ 5,501,420</td>
<td>$ 80,200</td>
</tr>
</tbody>
</table>