WORK-IN-PROGRESS

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Introduction

It has been my experience that not understanding the impact of work-in-progress on profitability (particularly at year-end), is the single most frequent cause of financial crisis for contractors. While this is one of the shortest bulletins in the series, its importance cannot be overstated.

Understanding the process and implementing it will help you generate a more realistic profit figure for your financial statements and show a much more realistic balance sheet.

Why the Problem?

Many trade contractors have difficulty assessing the value of work-in-progress at the end of every month (accounting period). This is because of their tendency to over-bill jobs to improve cash flow. If you are over-billed at the end of the month, you will show too much profit. Therefore, ensure that you prepare proper schedules so you can accurately assess the profit for the period and the year to-date.

Trade Contractors

Different types of contractors will have different approaches to evaluating work-in-progress. The process we are reviewing here is not suitable for service contractors, home builders, general contractors, or for any contractors that use the “completed contract” method of recognizing revenue. This bulletin applies to the typical HVAC, mechanical, sheet metal, electrical, roofing or drywall contractor who uses monthly progress billings as the base for calculating revenue.

Completed Contract Method

We do not recommend trade contractors use this format. If you use it make sure you really understand the implications on future profits and moving into higher tax brackets. You also want to watch for impact from capital tax (if applicable in your province). The percent complete method of recording your information will provide you with the most accurate results and the most even method of paying income tax. The tax paid will rarely work to your disadvantage. There are some potential deferrals when paying income tax, but it has been our experience that the “bad outweighs the good”.

The Process

The following examples compare what your records (ledgers) would reflect with the reality of the situation. There is a significant difference in each of these scenarios.

1	2	3	4	5	6	7	8
Contract value	Estimated cost	Estimated GP	Estimated markup	Billed to-date	Costs to-date	Expected billing to-date	(Under)/ over-billing
$	$	$	%	$	$	$	$
100,000	75,000	25,000	33%	80,000	70,000	93,333	(13,333)
200,000	160,000	40,000	25%	180,000	120,000	150,000	30,000
300,000	235,000	65,000	28%	260,000	170,000	217,021	42,979

COLUMN	DETAILS
1	Shows current contract value, including extras approved.
2	Shows estimated costs to generate above contract value.
3	Shows gross profit in dollars (1 minus 2).
4	Shows gross profit $ (3) as percentage of cost (2) – markup.
5	Shows accumulated billing per ledgers.
6	Shows accumulated costs per ledgers.
7	Shows what billing should be in relation to cost (7 × 5).
8	Shows under/over-billing (6 minus 8)

If you don't anticipate making the estimated profit, adjust cost (2) accordingly. The following columns would then change: 2, 3, 4, and 8.

Don't fool yourself into thinking you have generated profit you have not yet earned. At year-end, it is essential that this figure is correct, or you could end up paying tax on profit that you have not earned. Remember that **Net Holdback** (holdback on receivables less holdback on payables) is a tax deferral under current Canadian law.

Interpreting the Examples

The first contract is expected to show a gross profit of $25,000 on completion of $100,000 in sales. This is based on the estimate, which the company believes is realistic.

The ledgers are showing that the amount billed to-date at $80,000 is not consistent with the cost recorded to-date of $70,000; it is showing a profit of $10,000, which is 12.5% of sales, when in fact, we expect to make 25% on sales. In order to correct the ledgers we have three choices:

1. Do an evaluation of the percent complete and adjust both sales and cost in the ledgers.
2. Assume that the billing figure is correct and adjust the cost.
3. Assume the cost is correct and adjust the billing.

For simplicity purposes we have assumed that the costs recorded reflect the actual percent complete, and we are therefore adjusting the billing figure.

In the first contract we are showing an under-billing of $13,333. You can't bill the client to correct your ledger because you have already submitted your progress claim. Therefore, do a "reversing" journal: DR WIP; CR Sales. This will force the ledgers to reflect the correct status of the project. After you print your reports, reverse the journal so you don't carry forward this change. Complete this evaluation every month and do the appropriate reversing journals.

In the second and third contracts we see that we are over-billed $30,000 and $42,979. This means we are showing $72,979 in profits that we haven't earned. Our cash flow is going to look very sweet when we receive payment for our progress draws. If this is a year-end status we will be paying income tax on that profit (which we haven't earned); perhaps we will draw money from the company or pay bonuses. When reality catches up we could easily find ourselves in a major financial bind.

In order to correct our ledgers (using the same rationale as we did for the first contract) we would DR Sales $72,979 and CR WIP.

We can now show a true picture of our financial status and know our current situation from a profit and cash flow perspective. In addition to this, we will also have greater control over individual projects.