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A Primer on Accounting for Change Orders & Claims

No matter how thoughtfully it may be planned, critical changes can arise and can complicate a project. As a result, contractors frequently encounter change orders almost daily.

A change order can be initiated by either the contractor or the owner, and may encompass changes in specification or design, manner or method of performance, or other modifications. On more complex projects, change orders can significantly add to the final contract price.

While contractors are no strangers to project changes, it's imperative that they properly account for these changes in order to ensure the company's financial health.

Accounting for Change Orders

While accounting for approved change orders on the financial statement is fairly simple, accounting for unapproved change orders and claims can be challenging.

Unapproved change orders are heavily scrutinized by banks and bonding companies, which often take a conservative view on adjusting contract price until such changes are agreed to in writing.

If a contractor's bank and bonding company do not fully understand the specific facts and circumstances that resulted in changes to a contractor's estimated gross profit on a job, then unapproved change orders will be removed from contract price, causing assets to be removed from working capital and a decreased equity position. This can impact banking financial ratios and bonding program capacity, and lead to credibility and potentially lethal credit underwriting issues down the road.

In order to understand the accounting rules behind change orders and claims, contractors (and their financial advisors) must maintain a working knowledge of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts.*

Let's review a summary of the basic concepts around accounting for approved change orders, unpriced change orders, and unapproved change orders:

Approved Change Orders

In an approved change order, both parties approve the scope and price of the work. The work-in-progress (WIP) schedule will be impacted by an adjustment to the contract price and total estimated costs to reflect the amounts approved by the customer. Work performed relating to a change order that has been approved but not billed on the contract will most likely yield underbillings on the WIP schedule.

Approved & Unpriced Change Orders

An unpriced change order defines the work to be performed, but the price (i.e., the adjustment to the contract price) is negotiated at a later time.

For all unpriced change orders, recovery should be deemed probable if the events necessary for recovery are likely to occur and the contractor has experience in the conversion to priced and approved change orders. Factors to consider in evaluating whether recovery is probable include:

- The customer's written approval of the scope of the change order;
- Separate documentation for change order costs that are identifiable and reasonable; and
- The entity's favorable experience in negotiating change orders.

Should an approved and unpriced change order meet these factors, the contractor can properly recognize revenue to the extent of costs incurred to perform the additional work. All gross profit related to the changes in scope should be recognized once the change order is approved in writing.

Unapproved & Unpriced Change Orders

In an unapproved change order, costs are being incurred on work that has not been approved in either scope or price.

Depending on the circumstances, an unapproved change order that adjusts contract price and gross profit requires the most amount of scrutiny to determine if the amount is recoverable and most likely will result in a underbilling on the WIP schedule.

Accounting for unpriced change orders and unapproved change orders depends on the characteristics and underlying circumstances in which they occur. Here are some recommended approaches to accounting for these items under the percentage-of-completion method (PCM):

- Costs attributable to unpriced change orders should be treated as costs of contract performance for the period in which the costs are incurred.
- If it is not probable that the costs will be recovered through a change in the contract price, then the contract value and profit will drop as the company is recognizing unplanned costs without corresponding revenue. As a result, these unapproved changes will not show up as underbillings.
- If it is likely that the costs will be recovered through a change in the contract price, then the contract value and profit will change. Underbillings related to the change order will likely be reflected.
- Costs attributable to unapproved change orders and claims should be treated as costs of contract performance for the period in which the costs are incurred.

If it is probable that the contract price will be adjusted by an amount that exceeds the costs attributable to the unapproved change order, then the contract price should only be adjusted to the costs to be recognized and profit recognition should be deferred until the outcome is fully resolved.

Types of **Change Orders**

Change orders can be prompted by a variety of unpredictable issues – from changes in the project's concept, financial funding, or other fluctuations in the owner's circumstances to weather-related issues, natural disasters, or labor and material shortages.

Not all change orders will have an impact on the final project cost. Some of the drawing changes may be for the purpose of dimensional clarifications or additional notes for more information. Some change orders result from underbidding or a misunderstanding of the bid requirements.

The most common types of change orders on construction projects include:

- A fixed price change order that is agreed to by all contract parties
- An unpriced change order that is not agreed to by all contract parties, but will likely be approved during the process
- An unpriced change order that is not agreed to by all contract parties and likely will result in negotiation, contract dispute, or litigation
- Time and materials (T&M) change order approved by all contract parties
- T&M change order with final unit price negotiation to occur later in the process

Accounting for Construction Claims

If not properly addressed, unapproved change orders can become formal construction claims, which have a number of common causes:

- Delays in construction or completion of the contract
- Delays in the delivery and supply of materials
- Delays due to poor or unforeseen weather conditions
- Delays due to poor construction management and oversight of the project
- Difficult jobsite conditions or access not predicted during the estimating phase
- Owner-requested changes that do not receive approval, but the work is completed regardless
- Poor plan designs and inaccurate architectural and engineering drawings

The two most common methods to price out a potential project claim are the total-cost method and the direct-cost method.

Total-Cost Method

The total-cost method is a relatively straightforward calculation of the claim, accomplished by identifying 100% of the total costs specific to the project that are believed to be in excess of the estimated costs. The main disadvantage of this calculation method is that it is simply a calculation and does not properly attribute responsibility to the contracting parties.

Direct-Cost Method

The direct-cost method is a more time-consuming analysis. However, it is the preferred method used to build a formal claim amount primarily because it identifies specific events or conditions that gave rise to the actual additional costs that the contractor is contesting.

Recognizing Additional Claim Revenue

As one of the most difficult areas in construction accounting, recognizing additional revenue related to claims is only appropriate if it is highly probable that the claim will result in additional contract revenue and the amount can be reliably estimated.

All of the following conditions must exist for a claim to be recorded on contractor's financial statements:

- The contract or other evidence provides a legal basis for the claim, or a legal opinion has been obtained stating that, under the circumstances, there is a reasonable basis to support the claim;
- The additional costs are caused by circumstances that were unforeseen at the contract date and are not the result of deficiencies in the contractor's performance;
- The additional costs identified for the claim are determinable and reasonable in view of the work performed; and
- The actual documentation and evidence supporting the claim are objective and verifiable.

If any of the conditions do not exist, then the contract price should not be recorded (though the initial costs of the claim should still be recorded).

Instead, the details should be disclosed in the footnotes and contain enough information to allow the financial statement user to determine what, if any, financial credit should to be given to the contractor related to the final outcome of the claim.

Importantly, the most conservative approach for recording construction claims is to simply report an increase in contract price when payment is received related to the claim – i.e., the cash basis of accounting.

Reducing Risk

Given the cost control motive of the client vs. the profit motive of the contractor, the risk of construction claims and disputes are an industry norm.

Contractors and their clients should ensure that the original contract provides provisions to address the associated risks of change orders and claims to avoid the risk of additional expenses, strain on cash flow, project lien issues, or a potentially longer project completion time.

Timely submission, review, and approval of all change orders are also critical to a favorable outcome for all contract parties; the longer an issue is not addressed, the more likely a dispute and potential litigation may occur.

The best way to avoid construction claims is to implement systems and controls that address construction issues up front. The following common steps can help successfully mitigate the likelihood of project claims:

- Have a qualified legal expert perform a detailed review of all contract terms and conditions before a contract is executed
- Hire reputable contractors and consultants
- Consider a process to eliminate the possibility of accepting unusually low bids
- Implement effective job planning and management to avoid disputes
- Engage legal counsel with an expertise in construction litigation
- Resolve disputes early on in the project to avoid costly post-construction litigation

The Bottom Line

A contractor that fails to accurately record unapproved change orders and claims can create significant problems in its financial reporting.

When a change order is unpriced or otherwise unapproved, careful evaluation of the specific facts and circumstances is required prior to including it in a contract price.

Improperly recorded unapproved change orders and the contractor's inability to substantiate them may result in large underbillings and profit fade, which can concern banks and bonding companies. As a result, the contractor's ability to bid on larger jobs or additional work while maintaining proper financing could be adversely affected.

A contractor's ability to adhere to internal accounting policies and properly maintain files and records is crucial. Doing so will allow the contractor to evaluate change orders in a timely manner, properly reflect them in the financial statements, and take corrective action as needed. ■

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