COMBINING OR SEGMENTING CONTRACTS

Combining or segmenting contracts could yield materially different results when preparing financial statements. There are specific criteria for segmenting or combining contracts.

MASON BRUGH, CPA AND CHAD MADDOX, CPA, CVA

Paragraph 17, from Statement of Position 81–1 (SOP 81-1), *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, states:

> For the purpose of this statement a "profit center" is the unit for the accumulation of revenues and costs and the measurement of income. For the business enterprises engaged in the performance of contracts, the profit center for accounting purposes is usually a single contract; but under some specified circumstances it may be a combination of two or more contracts, a segment of a contract or of a group of combined contracts.

The Statement of Position was issued by the Accounting Standards Division of the American Institute of Certified Public Accountants. It gives accounting guidance to construction contractors.

This article discusses the criteria for combining or segmenting contracts. Contracts are typically written to be the profit center, because they were either negotiated or bid as one project. Because of this, projects do not often fit the criteria listed below for either combining or segmenting. However, there are occasions when the criteria should be examined.

Combining contracts

A contract is defined as an agreement between the owner and the contractor that details both the type of work to be performed on tangible property and the design specifications of that work. This simple concept often becomes complex when there are various construction activities to be completed over different time phases. Proper assessment of this concept is critical as combining or segmenting contracts could yield materially different results when preparing financial statements. Contracts may be combined if they:

a. are negotiated in same package with an overall profit margin objective.
b. constitute, in essence, an agreement to do a single project.
c. require closely interrelated construction activities with substantial common costs that cannot be separately identified with, or reasonably allocated to, the elements, phases or units of output.
d. are performed concurrently or in a continuous sequence under the same project management at the same location or at different locations in the same general vicinity.
e. constitute, in substance, an agreement with a single customer.

Separate contracts may still be considered "negotiated as a package" depending on the period of time between the contracts. The greater the time period between the contracts, the more likely it is that the economic circumstances impacting the negotiation process have changed. SOP 81-1 states the time period between commitments must be "reasonably short." When assessing whether there is an agreement with a single customer, the facts and circumstances relating to the other criteria should also be considered. For instance, two separate contracts are independently negotiated with different divisions of the same entity. This would not con-

MASON BRUGH is Director of Consulting for Shelton & Company, CPAs, P.C. He has over nine years' experience in the construction industry, serving as a controller for a systems contractor and as a CPA for Shelton & Company. CHAD MADDOX is Director of Auditing and Accounting for Shelton & Company, CPAs, P.C. He has responsibility for firm compliance with all current accounting and auditing rules and regulations. He has extensive construction accounting experience, having worked exclusively with contractors for over six years.

EXHIBIT 1 Sample: Combining Contracts

Year 1	***Contract A***	***Contract B***	***Contract A and B combined***
Estimated contract revenue	$ 575,000	$ 275,000	$ 850,000
Estimated contract costs	400,000	245,000	645,000
Estimated gross profit	$175,000	$ 30,000	$ 205,000
Gross Profit %	30%	11%	24%
Cost to date	100,000	240,000	340,000
Percentage of completion	25.00%	97.96%	52.71%
Revenues earned	143,750	269,388	448,062
Revenues earned from A and B as one combined profit center			$ 448,062
Revenues earned from A and B as separate profit centers			413,138
Difference in revenues earned			$ 34,924

stitute a single customer. On the other hand, negotiations conducted jointly with two or more entities at the same time to perform essentially a single project would be considered one customer. However, contracts should not be combined into a profit center solely to prevent losses on a particular contract from being recognized early in the estimating process.

When contracts meet the criteria, combining contracts into one profit center allows for ease in tracking costs if the work is performed in the same building or in a land development area. This would be extremely beneficial if the contractor moves employees from one contract to another at the same location and is pulling materials from the same "bin." It is quite possible that there are efficiencies in performing the contract in the above manner and an attempt to separate actual costs, as well as estimate the cost-to-complete for each contract, could prove to be inaccurate.

As stated above, care must be taken in the application of the combining or segmenting criteria to avoid distorting the financial statements. In the example illustrated in Exhibit 1, the revenue earned varies according to whether the contracts are combined or shown as separate profit centers.

The facts underlying Exhibit 1 are as follows: A customer approached the contractor to install a fire alarm system and a data infrastructure system in a new office building. The customer, due to budgetary restraints, needed separate contracts for both systems. While the fire alarm system was below the target gross profit, the combined contract prices of both systems met the target gross profit. Because the work on the separate systems would be completed in a relatively common time frame at the same location, the contractor signed the contracts expecting to incur increased efficiencies by combining project management and work crews. Because of this, the contractor concluded that there would be substantial common costs that would be difficult to separately identify to the different projects. Therefore, since the projects met the other combining criteria, they were presented on a combined basis in the financial statements.

Segmenting contracts

Some contractors may find it advantageous to segment contracts for accounting purposes if it can meet the criteria listed below. A contractor might negotiate for one lump-sum fee, a single contract representing three phases of the work on the project such as engineering, material sales, and construction. Because these phases are clearly separable and the profit margins for each differ substantially, as would the timing of the performance, the contractor may find it advantageous to segment the contract if it meets the criteria. Once a contractor adopts the practice of segmenting contracts, it must be used for both income recognition and determining the need to provide for anticipated losses.

In paragraphs 40 and 41, SOP 81-1 provides two sets of criteria, for either a single contract or group of contracts, that must be met in order to segment the contract. The first set of criteria requires

EXHIBIT 2 Sample: Segmenting Contracts

Year 1	***Phase 1***	***Phase 2***	***Total Contract with all Phases***
Estimated contract revenue	$ 600,000	$ 125,000	$ 725,000
Estimated contract costs	510,000	105,000	615,000
Estimated gross profit	$ 90,000	$ 20,000	$ 110,000
Gross Profit %	15%	16%	15%
Cost to date	510,000	-	510,000
Percentage of completion	100.00%	0.00%	82.93%
Revenues earned	600,000	-	601,220
Revenues earned from 1 and 2 as one combined profit center			601,220
Revenues earned from 1 and 2 as separate profit centers			600,000
Difference in revenues earned			$ 1,220

documentation and verification of the following steps taken in the process of entering the contract:

a. The contractor submitted bona fide proposals on the separate components of the project and on the entire project.
b. The customer had the right to accept the proposals on either basis.
c. The aggregate amount of the proposals on the separate components approximated the amount of the proposal on the entire project.

Once the contractor has taken these steps with proper documentation and verification, the contract may be segmented. The reasoning is that the separate functions of the contract were grouped for the convenience of the parties.

A project that does not meet the three criteria listed above may be segmented only if all of the following are met:

a. The terms and scope of the contract or project clearly call for separable phases or elements.
b. The separable phases or elements of the project are often bid or negotiated separately.
c. The market assigns different gross profit rates to the segments because of factors such as different levels of risk or differences in the relationship of the supply and demand for the services provided in different segments.
d. The contractor has a significant history of providing similar services to other customers under separate contracts for each significant segment to which a profit margin higher than the overall profit margin on the project is ascribed.
e. The significant history with customers who have contracted for services separately is one that is relatively stable in terms of pricing policy rather than one unduly weighted by erratic pricing decisions.
f. The excess of the sum of the prices of the separate elements over the price of the total project is clearly attributable to cost savings incident to combined performance of the contract obligations.
g. The similarity of services and prices in the contract segments and services and the prices of such services to other customers contracted separately should be documented and verifiable.

SOP 81-1, in paragraph 41, states that in applying criterion (d) "values assignable to the segments should be on the basis of the contractor's normal historical prices in terms of those services to other customers." The idea is to disallow a contractor to segment on the basis of prices charged by other contractors. A contractor with no history in the market may not be able to attain the same pricing structure as the other established contractors.

Once the segmenting criteria are met, the individual phase then becomes the profit center for accumulating costs and recognizing revenue. The profit margin for each phase may be different than the gross profit if the phases were treated as one profit center.

In the example illustrated by Exhibit 2, a single contract was segmented into two profit centers for accumulating costs and revenues.

The facts underlying Exhibit 2 are as follows: A hospital approached a contractor about installing a new nurse call system. In the solicitation process, the contract was bid as a whole and separated by the contractor into two phases—Phase 1 was the procurement of the materials and Phase 2 was the installation. In order to secure pricing, the hospital would have to order the materials six months before installation could begin. Because of the nature of the materials, the contractor did not want to take responsibility for their storage. The hospital agreed to order the materials in advance and take responsibility at its facilities for their safekeeping until the installation started. For budgetary reasons, the hospital still wanted to show all of the work under one purchase order. The project met the first three criteria for segmenting, and therefore the contractor separated the phases into separate profit centers and accounted for them accordingly.

Conclusion

On occasion, there are valid business reasons why some contracts may be combined, or conversely, segmented. However, as stated before, it is rare that a contract will meet the criteria for segmenting or combining. If contracts do meet the criteria, and will be segmented or combined, then the accountant should document the justification for the accounting. ■