White Paper 2014-10

Understand the Surprising Effects of Percentage-of-Completion Accounting on Project Financial Results

While Project Managers are rightfully focused on the end result of their projects (forecast at completion), they need to be aware that changes in their forecast will be amplified by the accounting methods when it comes to the short term profit recognition for large projects spanning over multiple years. Accounting principles sometimes lead to counter-intuitive results, and great opportunities from the Project Manager point of view could even turn into a short term loss that needs to be recognized by the organization!
This White Paper is complemented by White Paper 2014-11 on how to manage time-phasing to avoid surprises at the end of a financial reporting period.

In our experience, Project Managers are often unaware how their cost reports get processed by the organization to produce the organization's financial results. This White Paper intends to give a simple overview of this topic. More details of this essential issue are contained in our Cost Control Handbook.

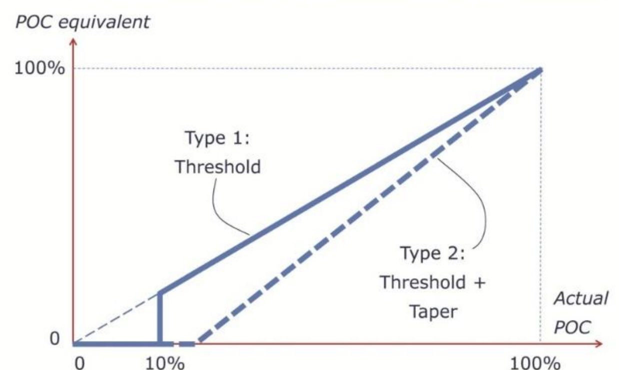
The Project Manager must be aware that POC accounting introduces a double whammy effect when it comes to the amplification of variances in EAC forecast

Basis of the Percentage-Of-Completion (POC) method

Percentage-of-Completion (POC) accounting is the most used accounting method when it comes to lump-sum construction projects profit & loss (P&L) accounting[1] and is described – with some variations – in all accounting standards, in their sections on project accounting (e.g. IAS 11).
The POC method allows the organization to recognize a part of the overall forecast profit of the project for the current accounting period, in proportion of the actual costs spent.
This method includes conservatisms that are appropriate for accounting to be a prudent view of the financial situation of the company:

- the Estimate At Completion (EAC) forecast is in itself a prudent and conservative estimate as it includes contingency and recognizes cost but not revenue of non-formally approved Variation Orders,
- The POC (percentage of Actual Cost/ Cost EAC) is also conservative and generally lower than the physical progress measured through other methods such as schedule progress (for example, some non-negligible physical progress is recognized at the award of procurement packages while no actual cost has been incurred).

To avoid misleading indications and inappropriate profit recognition early in a project, as a good practice, POC profit should at least not be recognized until the POC has reached a certain threshold level. This threshold is often fixed between 5% and 25% of POC progress. Some other organizations, in addition, use an even more conservative 'POC equivalent' to recognize project results during the course of the project, as shown on the figure:



Note: As an additional prudence rule, should the project be expected to be loss-making (as per the forecast EAC), the full loss is to be incurred immediately in the company's P&L (i.e., the full EAC loss is recognized immediately and not in proportion of the POC). This can have major impacts for organizations, and even more if they had recognized profit on this project at the beginning of execution, as it now needs to be reversed. It is one of the reasons for the introduction of more conservative 'POC equivalent' approach in some organizations.

Revenue phasing is not important in POC profit recognition

With POC accounting, revenue will be recognized in proportion of the POC and independently of the actual

[1] *The other acceptable accounting method is the completed-contract method, which would be excessively penalizing for a project-driven organization that executes multi-year contracts (as it recognizes profit only when the contract is completed). POC accounting, which is less prudent, is only accepted by auditors if the organization can demonstrate that it has appropriate systems and competencies to produce sound forecasts.*

revenue phasing based on milestones or physical invoices.

$$POC\ revenue = EAC\ revenue \times POC$$

Thus, time phasing of revenue is effectively only important for cash flow purposes, but not for profit recognition purposes.

The difference between the actual revenue billed to the Client / claimable by the project under the contract and the POC revenue will be treated by accounting through a specific provision which can be positive or negative depending on the contract specific payment terms.

The main focus of Project Managers should be their Forecast (EAC) profit at the end of the project, on which they are accountable.
However, Project Managers must be sensitive to the fact that changes to the forecast and cost time-phasing changes will have a very significant impact on the company's performance.

Instability of financial results due to POC accounting

The Project Manager must be aware that POC accounting introduces a double whammy effect when it comes to the amplification of variances in EAC forecast. This is of course, particularly applicable to multi-year projects.

Effect 1: Amplification of EAC variances between accounting periods

POC accounting introduces a serious instability of financial results: it significantly amplifies any variances of the EAC project profit between two different accounting periods.

This effect of POC amplification explains why consistency in EAC forecast is essential to avoid erratic financial results which don't correlate to the underlying result of the project. Even if the project remains profitable, a decrease in the forecast profit might lead through the POC effect to show a negative contribution for the year. It is of course even worse if at some time during the project, the EAC profit shows a loss because in that case, the entire loss needs to be immediately recognized, plus the reversal of any profit recognized in the previous accounting periods (this phenomenon explains some surprising profit warnings from project-driven companies when it happens to projects that are of very significant size compared to their overall revenue).

Effect 2: effect of variances in cost time-phasing

The second effect relates to the problem of the forecast of the POC progress itself. It is a general occurrence in project execution that project activities generally tend to be delayed compared to their original plan. This impacts the forecast P&L at the end of the accounting period.

This effect can have substantial impact on the end of year financial result recognition in particular if slippages of costs to the next year are only identified late in the year. The Project Manager needs to be particularly wary of that effect. This issue and how to deal with it is detailed in White Paper 2014-11.

Double whammy: the large unsigned Change Order

Let us now examine a double whammy situation: a large Change Order, which leads to additional costs, but to revenue that cannot be recognized because of ongoing negotiations. In that case, both the EAC profit will decrease (effect 1) and associate costs being mostly in the future, the overall spending profile of the project will lead to a lower POC (effect 2). As a result, even if the Change Order represents a great opportunity for the project final result, if can lead to a short-term severe degradation of the organization's financial results.

This will necessarily lead to tensions between the project and executive management. At that moment it is extremely important not to succumb to the temptation to recognize the additional associated revenue, which is a very dangerous practice as long as the Change Order is not signed.

Conclusion: be aware of the consequences of changes in your forecast

It should be clear that the main focus of Project Managers should be their EAC profit at the end of the project, on which they are accountable.

However, Project Managers must be sensitive to the fact that changes to the forecast and cost time-phasing changes will have a very significant impact on the company's performance, as these changes will be dramatically amplified by the POC accounting method.

Project Managers and their teams are not requested to drive accounting period profit recognition. What is expected is an accurate, good quality forecast of the Percentage Of Completion (POC) at the end of the accounting period that does not degrade excessively due to project execution delays, an excellent quality of EAC forecasts with the maximum control of its variance.

Find all these principles of Project Cost Control exposed in a comprehensive manner in our Handbook (2nd edition),
Practical Project Cost Control for Project Managers
(available in Paperback and Kindle versions!)
[all links to Amazon.com]

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