CPA Practice Advisor

Receivables Valuation

Every business wants to collect every dollar on every invoice they produce. However, the reality is that there may be write downs and partial payments and some invoices just won't get paid no matter how many follow up calls you make or letters you or ...

May. 12, 2016

Every business wants to collect every dollar on every invoice they produce. However,

and you are lucky enough to be able to collect all of the time and expenses charged to your projects then you do not need to worry about WIP reserves. However, if you have fixed price projects or you do not always collect 100% of the time and expenses charged to a project then you should be considering the use of WIP reserves.

Note: Some firms use the term 'Provisions' when referring to different methods of taking reserves against WIP and revenue, but the more familiar term is WIP Reserves. We'll use the term WIP Reserves in this paper.

So what exactly are WIP Reserves? Consider the following example:

Your project managers created the project budget using your firm's current standard rates and estimated 500 hours at $200 per hour or $100,000. However, for competitive reasons your firm has agreed to a fixed price of just $80,000. You go ahead and schedule two full time and one half time person for five weeks. At the end of the first week, as expected, your staff has put in 100 hours or $20,000 at your standard rate of $200/hour. Since you only expect to collect 80% of your standard rates, you have really earned $16,000. There are a number of ways you can account for the fact that you are planning on collecting 80% of your standard rates, three of which we have listed below:

Method	Pros	Cons
Change your "Project rate" to be 80% of your standard rates	If your system supports project rates then this is a simple way of changing the expected revenue for the project.	If the total estimate at completion changes there is no simple way of changing rates so that you have the correct revenue going forward.

Method	Pros	Cons
automatically create reserves	consistent across the organization.	supports this capability.

At the end of the third week you think all is progressing according to plan: the customer is happy, the project manager is optimistic and you are recognizing revenue based on approved hours times the $200 hourly rate times the 80% expected realization rate. So far, so good.

At the project status meeting Monday morning after the end of the third week the project manager casually mentions, "Uh, we've hit a bit of a snag and we're not so far along as we thought. In fact, I had to add another week or 100 hours to the schedule to make this thing work like we agreed to with the customer."

You realize that it is going to take a total of 600 hours to complete the project so you are just 50% complete (300 actual hours recorded divided by the 600 hours you are now estimating) not the 60% (300 actual hours recorded divided by the 500 hours originally estimated) you thought you were complete and a quick back of the envelope calculation confirms you've over-recognized revenue by $8,000 (calculations below)*

You call the project manager and ask whether or not the new estimate is because of a scope change or new requirements from the customer. "No" he says, "we just underestimated how long the project would take." You think there has to be a better and more accurate way to recognize revenue so unexpected revenue shocks can be avoided, or at least mitigated.

Why You Should Consider Using WIP Reserves

Using WIP reserves can help you measure revenue and value your WIP more

Different projects – for example, different billing methods, different durations or different risk levels – call for different WIP Reserves. Here are three types:

Percentage WIP Reserves

As described in our example, the ‘Percentage WIP Reserve’ method applies a 20% reduction against WIP and revenue for every hour recorded. Depending on the type of project, the percentage can be applied against either Project or Standard rates.

For Time & Materials projects where you’ve already agreed to a discount to your standard rates, you can apply the percentage to the negotiated rates as a hedge against customer push back on the final completed price or project quality.

For Fixed Price projects, such as the one used in our example, the best approach is to apply the percentage amount to your standard rates. The percentage reduction is applied to all transactions over the life of the project and will ensure your firm’s recognized revenue is in line with the project budget. If there are unforeseen problems, the percentage method can mitigate the damage and ensure the revenue and WIP write downs are acceptable rather than catastrophic.

Manual WIP Reserves

Manual WIP reserves are a one-time fixed amount reserve against project WIP. Manual WIP reserves can be useful when applied to short term projects or against longer duration projects as an extra hedge against unforeseen events. Manual WIP reserves are a one-time entry, while Percentage WIP reserves are applied as WIP and Revenue transactions are recorded over the life of the project.

Project Cap WIP Reserves

Another useful WIP Reserve method is a project cap reserve. If we change our first

Summary

When a project is completed, Finance will know the true realization rates – Realization at Project Rates is going to be project revenue and any other manual adjustments divided by project revenue and Realization at Standard Rates is going to be project revenue plus adjustments divided by standard revenue. In our first example above, at the three week mark, the planned 80% realization at standard rates has decreased to 67% at best – the $80,000 fixed price divided by $120,000 in standard revenue (600 hours at $200 per hour).

The wise CFO would much rather have the project manager predict 67% at the start and deliver 67% at completion than predict 80% or better and then force the CFO into an unexpected write down when the project encounters problems. WIP Reserves can help your firm avoid and mitigate unexpected revenue swings, better match your costs and your revenue and more accurately reflect your firm's asset values.

*How the $8,000 over-recognized revenue amount was calculated:

1 2 3 4 5

$48,000 – ($80,000 x (300 / (300 + 300)) = $8,000

1 Recognized revenue to date

2 Project fixed price revenue amount

3 Approved hours to date

4 Approved hours to date

William Cornfield is President and CEO of WSG Systems Corp., whose comprehensive enterprise software, Empire SUITE can help a firm better track due dates, manage accountability, reduce bottlenecks and prevent over and under-utilization.

Firm Management • Technology