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Accounting for Contract Retention Provisions

In today's construction industry, contracts typically include provisions for owners to withhold an amount of each progress billing, generally 5% to 10%, until the job reaches an agreed upon state of completion and, in most instances, general contractors pass these same retention provisions on to their subcontractors. These provisions are included as a safety net to ensure quality work and to offset additional costs incurred to hire a replacement should the contractor fail to meet his performance obligations. While the terminology is well known in the construction industry, its impact on the financial statements can be complicated.

Contractors account for revenues earned on long-term contracts using the percentage-of-completion method, and for most contractors percentage of completion is determined using the cost-to-cost method. This method determines job completion as a percentage of the contractor's costs incurred on the project to date compared to the contractor's total estimated cost of the project at completion. While in most industries increasing cost incurred during the year results in a reduction of the "bottom line," the opposite is true for contractors using the cost-to-cost method. Having additional costs on contracts in progress means that the job is closer to completion; thus, the contractor has earned a larger portion of the total contract amount.

Because cost plays such a large role in accounting for long-term contracts, it is integrally important that contractors record costs in the period in which they are incurred. Subcontractors typically bill the general contractor for the costs they have incurred as they install materials on the project. While amounts billed by subcontractors under contract-retainage provisions will not be paid until the project is complete, they still reflect progress being made on the job and should be recorded as a liability when the subcontractor's request for payment is received.

To help visualize this methodology, think of a subcontractor responsible for installing drywall in a building. When the drywall installer arrives at the jobsite, the building is framed in, but there are no walls. As the drywall, is installed the building becomes closer to being complete. The subcontractor bills the general contractor for the work performed, and the general contractor retains 5% of the balance owed to the subcontractor until the agreed-upon terms are met. Although the amount retained by the general contractor will not be paid until a later date, the drywall was still installed, bringing the job closer to completion. Accordingly, the general contractor should record the entire cost of the drywall installation on his books.

While amounts due to subcontractors under contract retainage provisions do increase the company's liabilities, they represent additional amounts that the general contractor has a right to collect from the owner. These additional amounts earned increase the asset called, "costs and estimated earnings in excess of billings," which results in retentions payable having a minimal impact on the contractor's balance sheet.

Retainage payable is recorded on the company's balance sheet with its trade accounts payable, however, balances that will not be paid within one year of the balance sheet date should be classified as noncurrent liabilities. In practice, many contractors opt to present all retentions payable as current liabilities and commonly disclose this in the notes to the financial statements.