



DANNIBLE & McKEE, LLP

Certified Public Accountants and Consultants

Delivering **Confidence**



Decoding A/E Financial Statements

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Charla A. Roth, CPA

Charla A. Roth, CPA, is a partner at Dannible & McKee, LLP and a principal at Dannible/McKee and Associates, Ltd and has over 23 years of experience providing audit, accounting and consulting services for a variety of clients. She specializes in working with architectural and engineering firms, and has extensive experience performing Federal Acquisition Regulation (FAR) overhead audits. In addition, she has managed the contract audit services with the New York State Department of Transportation from 2011 to the present. Charla also has proficient knowledge in numerous accounting software packages including Ajera, Deltek Vision, QuickBooks and more.

Academic and Professional Credentials

- Certified Public Accountant in New York State (CPA)
- Bachelor's of Science, Accounting, State University of New York at Oswego, 2002
- Master's of Accounting, State University of New York at Oswego, 2003

Professional Affiliations and Memberships

- American Institute of Certified Public Accountants (AICPA)
- New York State Society of Certified Public Accountants (NYSSCPA)
- Accounting & Financial Women's Alliance (AFWA) - Past-President and Treasurer

... About Dannible & McKee, LLP

- Dannible & McKee, LLP is a full-service CPA firm that delivers superior outcomes through a combination of technical knowledge, deep understanding of individual client's business and a commitment to personal, responsive service.
- Our clientele consists of companies across New York State and the United States and represents a diversity of business enterprises.
- Dannible & McKee is headquartered in Syracuse, NY and has additional offices in Binghamton, NY, Schenectady, NY, Auburn, NY and Tampa, FL.
- Specialize in working with Engineering and Architectural firms of all sizes and specialties.
- Provide assurance, accounting, tax, forensic, valuation and advisory services, along with FAR overhead rate audits and consulting.

Learn more at **dmcpas.com**

... Dannible/McKee and Associates, Ltd.

Dannible/McKee and Associates, Ltd has gained national recognition as one of the leading consulting firms to the A/E industry. For over 40 years, our consultants have worked with A/E firms throughout the country in determining the fair market value of their firm, developing creative strategies for ownership transfer and establishing buy/sell agreements among the owners to ensure success in the ownership transition process.



Learn more at **dmconsulting.com**

... Introduction

Important questions:

- Do your internal financial reports provide all of the information needed to most effectively manage your firm?
- Do users of financial statements have a good understanding of the reports provided to them?
- Could decision making be improved if better financial analysis was performed?

Uses of your accounting and financial reporting system.

External financial reporting.

Income tax compliance.

Internal reporting and analysis – Managing your Firm for Profitability!

You must go beyond the basic statements.

- The balance sheet and income statement are only the starting point for successful financial management.
- Applying other financial statement analysis methods is a necessary step in analyzing the success, failure, and progress of your business.
- It is also critical for a firm to understand and utilize detailed reports available in its accounting system.

Accounting Software Packages

Specifically designed for A/E firms

- Deltek Vision / Vantagepoint
- Deltek Ajera
- Unanet / Clearview

General accounting software

- QuickBooks
- Peachtree (MAS 50)

With general accounting software, A/E firms often use an add-on package for timekeeping and project management

... The Balance Sheet

- Represents a snapshot of the financial position of the firm at a specific point in time.
- Demonstrates the basic accounting equation whereby:

$$\text{Assets} - \text{Liabilities} = \text{Stockholder's Equity}$$

- Balance sheets for A/E firms are not significantly different from other businesses.
- The most significant assets are usually accounts receivable and work in process.
 - **Accounts receivable** – Represents amounts billed to clients for the performance of services. Should be reduced by allowance for uncollectible accounts.
 - **Work in process** - Represents the costs accumulated for contracts in progress, which include direct labor and direct/reimbursable expenses. Work in process reflected on the firm's balance sheet should be reported at **full billable value**.

Sample Balance Sheet: Accrual Basis

	For the Year Ended December 31,				Variance	
	2024		2023			
	Amount	%	Amount	%	Amount	%
Assets						
<u>Current assets:</u>						
Cash	\$ 152,015	2.75%	\$ 191,828	3.85%	\$ (39,813)	-20.75%
Accounts receivable	2,612,528	47.33%	2,687,590	53.99%	(75,062)	-2.79%
Work-in-process	1,604,778	29.08%	926,350	18.61%	678,428	73.24%
Refundable income taxes	8,437	0.15%	4,987	0.10%	3,450	69.18%
Prepaid expenses & other assets	44,786	0.81%	59,126	1.19%	(14,340)	-24.25%
Total current assets	4,422,544	80.13%	3,869,881	77.74%	552,663	14.28%
<u>Long-term assets:</u>						
Fixed assets, net	970,025	17.57%	985,927	19.81%	(15,902)	-1.61%
CSV life insurance	126,785	2.30%	121,963	2.45%	4,822	3.95%
Total long-term assets	1,096,810	19.87%	1,107,890	22.26%	(11,080)	-1.00%
Total assets	\$ 5,519,354	100.0%	\$ 4,977,771	100.00%	\$ 541,583	10.88%
<u>Liabilities and Stockholders' Equity</u>						
<u>Current liabilities:</u>						
Accounts payable	\$ 726,842	13.17%	\$ 731,277	14.69%	\$ (4,435)	-0.61%
Accrued liabilities	220,897	4.00%	238,591	4.79%	(17,694)	-7.42%
Current portion of long-term debt	134,492	2.44%	107,572	2.16%	26,920	25.03%
Line of credit	800,000	14.49%	500,000	10.04%	300,000	60.00%
Deferred income taxes	1,017,500	18.44%	926,400	18.61%	91,100	9.83%
Total current liabilities	2,899,731	52.54%	2,503,840	50.30%	395,891	15.81%
<u>Long-term liabilities:</u>						
Long-term debt	385,618	6.99%	324,518	6.52%	61,100	18.83%
Deferred income taxes	60,500	1.10%	28,200	0.57%	32,300	114.54%
Deferred compensation	132,152	2.39%	126,933	2.55%	5,219	4.11%
Total liabilities	578,270	10.48%	479,651	9.64%	98,619	20.56%
<u>Stockholders' equity:</u>						
Common stock	50,000	0.91%	50,000	1.00%	-	0.00%
Additional paid-in-capital	250,000	4.53%	250,000	5.02%	-	0.00%
Retained earnings	1,741,353	31.55%	1,694,280	34.04%	47,073	2.78%
Total stockholders' equity	2,041,353	36.99%	1,994,280	40.06%	47,073	2.36%
Total liabilities & stockholders' equity	\$ 5,519,354	100.0%	\$ 4,977,771	100.01%	\$ 541,583	10.88%

Income Statement

- A period-to-date summary of revenue and expenses that calculates the net income or loss for the period.
- The income statement format for an A/E firm differs significantly from that of a manufacturing or retail entity due to the nature of closely held professional service firms.
- “Bottom line” net income or loss often is not truly representative of the firm’s profitability due to discretionary bonuses paid to a firm’s owners at year-end in addition to other discretionary expenses.
- The proper income statement format is essential in order to manage the firm for profitability in addition to providing comparisons with peer firms in the A/E industry.

Income Statement

Specific key elements of the firm's income statement:

- Gross revenue – Represents gross fees billed to clients including reimbursable expenses.
- Net revenue – Defined as the firm's gross revenue less reimbursable expenses.
 - This is the revenue earned on the firm's labor and is used as a basis for providing income statement comparisons and comparisons with industry standards.

Income Statement

- Direct labor – Represents labor charged directly to projects based on time incurred on projects at the billable rates established by the firm for the level of personnel engaged on the project.
 - Many financial ratios and metrics for design firms are expressed as a percentage of direct labor for comparability.
 - Industry standard percentage of direct labor to net revenue is often in the range of 32% to 34%.
- Contribution margin – Defined as the firm's net fee revenue less direct labor and direct project expenses.
 - So named because it represents the firm's "contribution" to cover overhead expenses and provides for net profit.
 - Industry standard gross profit percentage is often in the range of 66% to 68%.

Income Statement

- Indirect expenses – Overhead expenses in connection with the firm's operations including labor overhead (payroll taxes, insurance, benefits, etc.), occupancy costs, marketing costs and office expenses.
- Net income before discretionary items – Represents the firm's pre-tax net income available for discretionary payouts such as shareholder bonuses, employee bonuses and retirement plan contributions.
 - Most significant performance measure of the firm's profitability in comparison with peer firms.
 - Industry standard ratio of pre-discretionary net income to net revenue is often in the range of 8% to 15%.

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Sample Income Statement: General Format

ABC Engineers, Inc.
Traditional Income Statement
For the Year Ended December 31, 2024

	Amount	%
Revenue	\$ 9,882,468	100.00%
Cost of sales	1,728,362	17.49%
Gross profit (margin)	8,154,106	82.51%
<u>Selling, general & administrative expenses</u>		
Payroll expense	4,732,596	47.89%
Vacation, sick & holiday pay	526,847	5.33%
Payroll taxes	486,597	4.92%
Fringe benefits	426,580	4.32%
Office rent expense	333,000	3.37%
Depreciation	236,215	2.39%
Other Operating Expenses	968,105	9.80%
Total indirect expenses	7,709,940	78.02%
Operating income	444,166	4.49%
Other income / (expense)		
Interest income (expense)	(52,615)	-0.53%
Other income	11,252	0.11%
Pre-tax net income	402,803	4.08%
Income tax expense	(120,000)	-1.21%
After-tax net income	\$ 282,803	2.86%

Sample Income Statement: A/E Format

ABC Engineers, Inc. Income Statement - A/E Format

	For the Year Ended December 31,			
	2024		2023	
	Amount	% Net	Amount	% Net
Gross revenue	\$ 9,882,468	118.59%	\$ 10,856,901	134.50%
Reimbursable expenses	1,549,410	18.59%	2,785,074	34.50%
Net revenue	8,333,058	100.00%	8,071,827	100.00%
Direct labor	2,685,624	32.23%	2,731,584	33.84%
Direct expenses	178,952	2.15%	182,684	2.26%
Gross profit (margin)	5,468,482	65.62%	5,157,559	63.90%
<u>Indirect expenses</u>				
Indirect labor	1,696,972	20.36%	1,772,843	21.27%
Vacation, sick & holiday pay	526,847	6.32%	452,480	5.43%
Payroll taxes	486,597	5.84%	490,506	5.89%
Fringe benefits	276,580	3.32%	256,843	3.08%
Office rent expense	333,000	4.00%	333,000	4.00%
Depreciation	236,215	2.83%	234,009	2.81%
Other Operating Expenses	968,105	11.62%	984,587	11.82%
Total indirect expenses	4,524,316	54.29%	4,524,268	54.29%
Operating income	944,166	11.33%	633,291	7.85%
Other income / (expense)				
Interest income (expense)	(52,615)	-0.63%	(59,158)	-0.73%
Other income	11,252	0.14%	7,591	0.09%
Net income before discretionary items	902,803	10.83%	581,724	7.21%
Discretionary bonuses	350,000	4.20%	-	0.00%
Profit-sharing contribution	150,000	1.80%	150,000	1.86%
Pre-tax net income (loss)	402,803	4.83%	431,724	5.35%
Income tax expense	(120,000)	-1.44%	(110,000)	-1.36%
After-tax net income	\$ 282,803	0.83%	\$ 321,724	0.83%

Statement of Cash Flows

- A period-to-date summary of sources and uses of the firm's cash.
- Calculates the change in cash from the beginning of the period to the end of the period.
- Illustrates the sources and uses of the firm's cash between three broad categories of activities.
 - **Operating activities** – Include the sales and delivery of services and cash paid in connection with the performance of those services (i.e. labor, outside consulting and reimbursable expenses).
 - **Investing activities** – Include primarily the purchase and/or sale of property, plant and equipment.
 - **Financing activities** – Include inflow of cash from banks and shareholders and the outflow of cash for debt repayments and dividends.

... FAR Overhead Rate Statement

- Required for many Engineering firms and some Architectural firms that do work for Federal, State or local government agencies
- Calculates the overhead rate from the firm's annual income statement
- Makes adjustments in accordance with FAR Part 31 including subtracting unallowable expenses
- Can be prepared internally or audited by a CPA firm

FAR Overhead Rate Statement

	Indirect Expenses in Annual Financial Statements	Note Reference	FAR Adjustments to Indirect Expenses	Eligible Indirect Expenses in Accordance with FAR
Indirect expenses:				
Salaries and wages	\$ 250,000		\$ -	\$ 250,000
Payroll taxes and benefits	84,000		-	84,000
Rent expense	20,000		-	20,000
Depreciation	60,000	(A)	(3,000)	57,000
Advertising expense	24,000	(B)	(24,000)	-
Telephone expense	15,000		-	15,000
Insurance expense	65,000	(C)	(12,000)	53,000
Profit sharing plan	15,000		-	15,000
Business relations	5,000	(D)	(5,000)	-
Office supplies	10,000		-	10,000
Professional fees	125,000	(E)	(20,000)	105,000
Contributions	4,000	(F)	(4,000)	-
Dues and subscriptions	3,000	(G)	(1,000)	2,000
Utilities	13,000		-	13,000
Vehicle expense	46,000	(H)	(20,000)	26,000
Other expenses	2,000	(I)	(1,000)	1,000
Repairs and maintenance	15,000		-	15,000
Permits and licenses	6,000		-	6,000
Bad debts	3,000	(J)	(3,000)	-
Travel expense	5,000		-	5,000
Professional development	8,000	(K)	(3,000)	5,000
Interest expense	8,000	(L)	(8,000)	-
Total indirect expenses	<u>\$ 786,000</u>		<u>\$ (104,000)</u>	<u>\$ 682,000</u>
Facilities capital cost of money	\$ -	(M)	\$ 14,000	\$ 14,000
Direct labor	<u>\$ 450,000</u>		<u>\$ -</u>	<u>\$ 450,000</u>
Overhead rate computation on direct labor:				
Indirect expenses	<u>174.67%</u>			<u>151.56%</u>
Facilities capital cost of money	<u>0.00%</u>			<u>3.11%</u>

... Methods of Accounting for A/E Firms

Cash Method of Accounting

- **Income Recognition** - Revenue is recognized when cash is received; expenses are recognized when cash is paid
- **Flexibility** - Popular because of its flexibility and most small businesses are allowed to use this method for tax reporting purposes
 - Depending on the form of entity and the nature of the business, a “small” business with gross receipts of less than \$25 million may be allowed to utilize the cash method of accounting
- **Personal Service Corporations (PSC) - PSCs** are allowed to use the cash method for tax reporting purposes regardless of the level of gross receipts
 - A/E firms typically meet the statutory definition of a **PSC** because substantially all (95%) of the time spent by employees is devoted to the performance of specified professional services and substantially all (95%) of the value of the firm’s stock is owned by employees who perform such services
 - C Corporation PSCs are now subject to a flat Federal income tax rate of 21% due to the **2017 Tax Cut and Jobs Act**

... Methods of Accounting for A/E Firms

DEF Associates, P.C. Historic Balance Sheet - Cash Basis

<u>Assets</u>	December 31,	
	<u>2024</u>	<u>2023</u>
Current assets:		
Cash and money market funds	\$ 186,247	\$ 136,821
Advances - stockholders	6,241	14,516
Other receivables	7,600	4,000
Total current assets	<u>200,088</u>	<u>155,337</u>
Fixed assets:		
Land	10,000	10,000
Building and building improvements	420,000	400,000
Furniture and fixtures	320,429	255,402
Automobiles	25,679	25,679
	<u>776,108</u>	<u>691,081</u>
Less: Accumulated depreciation	<u>(393,359)</u>	<u>(327,613)</u>
Net fixed assets	<u>382,749</u>	<u>363,468</u>
Cash value of officers' life insurance	<u>12,900</u>	<u>6,200</u>
Total assets	<u>\$ 595,737</u>	<u>\$ 525,005</u>

... Methods of Accounting for A/E Firms

DEF Associates, P.C. Historic Balance Sheet - Cash Basis

<u>Liabilities and Stockholders' Equity</u>	<u>December 31,</u>	
	<u>2024</u>	<u>2023</u>
Current liabilities:		
Current portion of long-term debt	\$ 46,500	\$ 32,500
Demand note payable	138,200	105,400
Payroll taxes withheld	21,500	20,200
Total current liabilities	<u>206,200</u>	<u>158,100</u>
Long-term debt	<u>260,000</u>	<u>215,000</u>
Stockholders' equity:		
Common stock	15,000	15,000
Retained earnings	114,537	136,905
Total stockholders' equity	<u>129,537</u>	<u>151,905</u>
Total liabilities and stockholders' equity	<u>\$ 595,737</u>	<u>\$ 525,005</u>

... Methods of Accounting for A/E Firms

DEF Associates, P.C. Historic Income Statement - Cash Basis

	December 31,	
	2024	2023
Net fees	\$ 3,127,000	\$ 2,067,000
Operating expenses:		
Officers' salaries	472,100	360,000
Salaries - employees	1,195,237	857,732
Automobile expense	18,200	8,860
Depreciation	86,600	62,840
Duplication/printing	232,160	113,700
Employee insurance and benefits	146,700	88,520
Insurance	113,460	58,210
Legal and accounting	18,921	12,321
Miscellaneous	32,160	41,621
Office expense	210,000	93,200
Payroll taxes	152,300	108,210
Postage	43,000	33,600
Rent	245,000	52,126
Telephone	31,698	19,643
Temporary services	8,210	8,300
Travel and entertainment	108,622	78,321
Total operating expenses	<u>3,114,368</u>	<u>1,997,204</u>
Operating income	<u>12,632</u>	<u>69,796</u>
Other receipts and (disbursements):		
Interest expense	(63,200)	(43,275)
Interest income	28,500	18,200
Miscellaneous revenue	<u>4,200</u>	<u>6,200</u>
	<u>(30,500)</u>	<u>(18,875)</u>
Excess of receipts over disbursements before income taxes	(17,868)	50,921
Income tax expense	<u>3,500</u>	<u>5,300</u>
Net receipts (loss)	<u>\$ (21,368)</u>	<u>\$ 45,621</u>

... Methods of Accounting for A/E Firms

Advantages of Cash Method of Accounting

- Ease of use – cash basis books and records are easy to maintain
- Verifiability – cash balance is easily reconcilable with bank account balances
- Federal income tax reporting – allowed for income tax reporting purposes which enables firms to properly “manage” taxable income through proper planning of year-end discretionary expenses (i.e. bonuses) and expense pay-downs (existing accounts payable, sub-consultants payable and prepaid expenses)

... Methods of Accounting for A/E Firms

Disadvantages of Cash Method of Accounting

- Cash method of accounting is not in accordance with generally accepted accounting principles (GAAP)
- In a professional service firm, the cash method of accounting significantly understates the firm's income and net worth
- Net income is understated because the cash method of accounting does not recognize revenue from amounts billed to clients for services performed
- The firm's net worth is understated because the cash method of accounting does not recognize the two most significant assets of the firm – work-in-process and accounts receivable
- As a result, the cash method is not appropriate for
 - Financial reporting purposes
 - Managing the firm for profitability
 - Valuation purposes

... Methods of Accounting for A/E Firms

Accrual Method of Accounting

- Revenues are reported when earned; expenses are reported when incurred
- For a professional service firm, revenue is recognized when it is billed; expenses are recognized when an invoice or bill is received or in the event GAAP requires expense recognition for non-vendor type expenses (i.e. accrued expenses such as payroll liabilities)
- Accrual method of accounting better reflects the profitability and net worth of the underlying business and is required under GAAP
- Accrual method of accounting is essential to properly managing the firm for profitability

... Methods of Accounting for A/E Firms

DEF Associates, P.C. Historic Balance Sheet - Accrual Basis

<u>Assets</u>	<u>December 31,</u>	
	<u>2024</u>	<u>2023</u>
Current assets:		
Cash and cash equivalents	\$ 186,247	\$ 136,821
Trade accounts receivable	962,000	612,500
Work-in-process	186,210	208,300
Less: Allowance for doubtful accounts	(83,520)	(26,000)
Net accounts receivable	1,064,690	794,800
Prepaid expenses	76,200	23,500
Due from stockholders	6,241	14,516
Other receivables	7,600	4,000
Total current assets	1,340,978	973,637
Property and equipment:		
Land	10,000	10,000
Building and building improvements	420,000	400,000
Furniture and fixtures	320,429	265,402
Automobiles	25,679	25,679
	776,108	701,081
Less: Accumulated depreciation	(393,359)	(339,761)
Net fixed assets	382,749	361,320
Cash value of officers' life insurance	12,900	6,200
Total assets	<u>\$ 1,736,627</u>	<u>\$ 1,341,157</u>

... Methods of Accounting for A/E Firms

DEF Associates, P.C. Historic Balance Sheet - Accrual Basis

<u>Liabilities and Stockholders' Equity</u>	<u>December 31,</u>	
	<u>2024</u>	<u>2023</u>
Current liabilities:		
Current portion of debt	\$ 46,500	\$ 32,500
Demand note payable	138,200	105,400
Deferred income taxes	220,000	170,000
Trade accounts payable	376,000	353,000
Client retainers	83,000	-
Payroll taxes withheld	21,500	20,200
Other accrued liabilities	87,266	77,332
Total current liabilities	972,466	758,432
Deferred income taxes	48,000	16,000
Long-term debt	260,000	215,000
Stockholders' equity:		
Common stock	15,000	15,000
Retained earnings	441,161	336,725
Total stockholders' equity	456,161	351,725
Total liabilities and stockholders' equity	\$ 1,736,627	\$ 1,341,157

... Methods of Accounting for A/E Firms

DEI Associates, P.C.

Historic Income Statement - Accrual Basis

	December 31,	
	2024	2023
Net fees	\$ 3,413,390	\$ 2,446,121
Operating expenses:		
Officers' salaries	472,100	360,000
Salaries - employees	1,249,894	892,721
Automobile expense	18,200	8,870
Bad debt expense	43,000	10,000
Depreciation	86,600	62,840
Duplication/printing	232,160	126,200
Employee insurance and benefits	146,700	98,200
Insurance	113,460	46,100
Legal and accounting	12,231	22,060
Miscellaneous	36,400	28,321
Office expense	217,361	123,127
Payroll taxes	152,300	118,210
Postage	41,762	26,210
Rent	245,000	163,688
Telephone	32,721	21,186
Temporary services	8,210	16,182
Travel and entertainment	121,602	71,210
Total operating expenses	3,229,701	2,195,125
Operating income	183,689	250,996
Other income (expense):		
Interest expense	(63,200)	(43,275)
Interest income	28,500	18,200
Miscellaneous income	4,200	6,200
	(30,500)	(18,875)
Net income (loss) before income taxes	153,189	232,121
Provision for income taxes:		
Current taxes (refund)	(11,000)	25,000
Deferred tax	82,000	40,000
	71,000	65,000
Net income (loss)	\$82,189	\$167,121

... Generally Accepted Accounting Principles

- **GAAP** is a collection of guidelines and practices used to prepare, present and report financial statements for business entities including publicly-traded corporations, privately-held companies, not-for-profit organizations and governments
- In the United States, GAAP standards are not controlled by the Federal or state governments, but are instead entrusted to the private sector, governed by the **Financial Accounting Standards Board (FASB)**
- The **FASB** is a non-governmental not-for-profit organization whose primary purpose is to develop, establish and improve standards of financial accounting and reporting
- The SEC designated the **FASB** as the organization responsible for setting accounting standard for public companies in the United States in 1973

... Generally Accepted Accounting Principles

Characteristics of GAAP

- Separate Entity – the business is separate from its owners and other businesses; revenue and expenses should be kept separate from personal expenses
- Substance Over Form – GAAP consists of a set of complex and detailed accounting rules that leave little room for individual judgment
- Going Concern / Continuity – the assumption that a business will continue to operate indefinitely, and will not go out of business and liquidate its assets
- Conservatism – this concept is often referred to as “anticipate all losses, but not all profits” and can result in a significant understatement of net assets and profits in the preparation of financial statements

... Generally Accepted Accounting Principles

Characteristics of GAAP – Continued

- Historical cost – Requires companies to account and report financial transactions based on acquisition costs rather than fair market value for “most” assets and liabilities
- Recent accounting standards have been issued which reflect a greater emphasis on fair value reporting. Although the historical cost principle has not been abandoned, FASB will be requiring companies to record a growing number of assets and liabilities at fair value
- Consistency – All information should be gathered and presented the same across all periods

... Generally Accepted Accounting Principles

Characteristics of GAAP – Continued

- Matching – Expenses should be matched with revenue as long as it is reasonable to do so. Expenses are not recognized with the work is performed, but when the work makes its contribution to revenue
 - Only in the event that no connection to revenue can be established, may costs be charged as expenses in the current period (e.g. administrative expenses)
- All inclusive concept – Includes all revenues, expenses, gains and losses recognized during the period for which a financial statement is being presented

... Accounting Principles for Design Firms

Differences in Accounting Principles

- Accounting principles can differ from firm to firm and have a significant impact on the reported profitability or financial position of the firm
- Choices of different methods of calculating depreciation
- Choices of capitalizing vs. expensing
- Choices of recording a liability when incurred or when paid
- Choices in methods of accounting for long-term contracts

... Accounting Principles for Design Firms

Methods of Accounting for Depreciation

- **Straight-Line Method** - Fixed assets are depreciated ratably over their estimated useful life
- **Double Declining Balance Method (DDB)** - An accelerated depreciation method whereby the asset is depreciated at double the straight-line rate
- **Federal Income Tax Depreciation Methods** - Includes DDB and Internal Revenue Code (IRC) Section 179 election and IRC Section 168(k) “bonus” depreciation
 - IRC Section 179 allows for the expensing of certain fixed asset additions up to a statutory limit (currently \$1,000,000)
 - IRC Section 168(k) provides for the expensing of 100% of the cost of qualifying fixed asset additions
 - These depreciation methods are not allowable under GAAP

... Accounting Principles for Design Firms

Choices of “Capitalizing” Versus “Expensing” - Repairs and maintenance expenditures, improvements on property or equipment or fixed assets

- An example of this is the acquisition of ERP accounting software where a portion of the total cost of implementation is typically segregated into capitalizable fixed assets to be depreciated over its estimated useful life and current expenses which are charged to operations in the year incurred

Choices of Recording a Liability when Incurred Versus when Paid (e.g. vacation and sick pay liabilities)

... Accounting Principles for Design Firms

Methods of Accounting for Long-Term Contracts

Percentage of Completion

- Revenue is recognized ratably as the contract is completed; expenses are recognized as incurred
- Costs allocated to the contract incurred as of the end of the period are compared to total estimated costs of the contract to determine the percent complete
- The percent complete is applied to the contract amount to determine the revenue to be recognized on the contract

Accrual - Revenue is recognized as contract amounts are billed; expenses are recognized as incurred

Completed Contract - Revenue and expenses on long-term contracts are recognized in the year the contract is complete

... Improved Financial Statement Analysis

You must go beyond the basic statements.

- The balance sheet and income statement are only the starting point for successful financial management.
- Applying other financial statement analysis methods is a necessary step in analyzing the success, failure, and progress of your business.

Other types of financial statement analysis include:

- Fluctuation analysis
- Common size financial statements
- Ratio analysis – ***This will be covered in our next presentation!***
- Industry comparison

Fluctuation Analysis

- Fluctuation analysis represents the study of changes in amounts from period to period.
- Analyze both dollar changes and percentage changes.
- Use statements with fluctuation data presented.
- Understand relationships among different balances.
 - These relationships can help to explain a significant fluctuation.
 - In addition, they can lead you to investigate why a balance did not change from year-to-year as expected based on changes in related balances.

Utilizing Budget and Forecasts

- It is difficult to run a business without a plan!
- Goals need to be established.
- It also critical that reports compare actual data to budgets.
 - With appropriately detailed budgets, variances between actual and planned performance easily can be identified.
 - With proper analysis of the cause of the variance, management can respond to get operations back on track.
 - Too often significant time is spent preparing budgets that aren't used during the year.
 - Remember that budgets are only useful if they are used in analysis!

••• Detailed Reports

- The basic financial statements are not sufficient to effectively manage the company!
 - A firm must analyze more than just its balance sheet and income statement and the high-level ratios discussed above.
 - Detailed reports must be utilized by personnel throughout the firm.
- Accounting software is capable of producing countless detailed reports that can be tailored to the specific needs of your firm.
- For all reporting, consider meaningful breakdowns including by division, location, type of client, type of project or project manager.

••• Detailed Reports

- Categories for detailed accounting reports include:
 - General ledger reports
 - Subsidiary ledgers and reports
 - Accounts receivable
 - Work in process
 - Accounts payable
 - Journals
 - Sales
 - Purchasing
 - Cash disbursements
- For A/E firms, some of the most critical reports related to analysis of job profitability and labor utilization.

Specific Reports for Engineering Firms

- Labor Utilization Reports
 - By labor hours
 - By labor dollars
- Job Cost Reports
 - Budget
 - Actual
- Work in Process Aging
- Profitability/Multiplier by Job
- Overhead Schedules

Timing and Distribution of Reports

- Financial reporting is only effective if the right people get the right reports!
- Frequency of reports
 - Reports should be produced at least monthly.
 - Depending on the capabilities of your systems and the nature of your business, more frequent reports may also be appropriate.
 - Sales, production and other types of reports may be needed daily or weekly as explained below.
- Periods included
 - Current month.
 - Year to date.
 - Any other meaningful grouping, including possibly quarter to date or rolling twelve months.

Timing and Distribution of Reports

- Timeliness
 - Reports need to be provided soon enough to be relevant for decision making!
 - In no event should monthly statements take longer than two weeks into the following month (and hopefully they can be provided much sooner than that)!
 - Some reports, such as employee utilization, might be produced on a weekly or even daily basis.
 - If certain data or reconciliations delay the financial statements, make estimates and adjust in the following month.

Timing and Distribution of Reports

- Report Distribution
 - It is critical to determine which reports are relevant for specific personnel and groups of personnel.
 - Verify that personnel are understand and are effectively using data.
 - Obtain feedback on how reporting can be improved.
 - Distribute electronically!

Ratio Analysis and Benchmarking

- Financial statements can be analyzed using key financial ratios.
- Financial ratios are a numeric calculation involving the comparison of meaningful amounts from the financial statements.
- Ratios are not ends in themselves, but provide insights into the operation of a firm.
- They serve as “benchmarks” against which the firm can evaluate itself and are only useful when:
 - Compared with the same ratios, for the same firm, from previous periods.
 - Compared with some predetermined standard.
 - Compared with the same ratios for other firms in the same industry.
 - Compared with average ratios for the industry within which the firm operates.

... Analyze and Take Action

- Effective financial analysis is a four-step process.
 - Prepare the proper reports.
 - Distribute the reports to appropriate personnel timely.
 - Perform analysis.
 - Make management decisions based on the analysis.
- It is critical that actual analysis is performed.
 - Unfortunately, many firms stop somewhere between step 1 and step 2!
 - Consider how much time is spent producing financial data versus the time spent using that data.
 - Make time to perform analysis!

... Analyze and Take Action

- Financial analysis should be documented.
 - This allows the analysis to be distributed to others in the firm.
 - In addition, such analysis will be useful to the person performing as they do their work in future periods.
 - Such analysis can take many forms and you should consider what is easiest for the person performing the analysis and those that will use it. It could be in the form of:
 - E-mails.
 - Formal memos
 - Notes in an Excel spreadsheet.
 - Explanations written in the margins of a report.
- Financial analysis is only effective if you follow through by taking action based on your analysis.

Conclusion

- Consider your overall knowledge of accounting and the financial reporting process for your firm.
- Determine if the basic financial statements are properly formatted for an engineering firm.
- Evaluate the detail reports that are being produced and whether they are being distributed to the appropriate people.
- Review the actual financial analysis that is performed and consider improving the documentation of this analysis.
- Make certain that action is taken and decisions are made based on the financial analysis that is performed.

Conclusion

- Change is needed to achieve improved results - Don't be afraid to change.
- Consider how you can make the best use of the capabilities in your financial software.
- Be certain to analyze the cost versus benefit of any financial management project, including a project to improve financial reporting and analysis.
- Remember that financial analysis is a powerful tool that can help you run your firm more effectively and profitability.

Questions



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