

Hot Button Issues in Construction Accounting & Financial Management

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The construction industry is experiencing many of the same issues and problems as other American businesses: global competition, rapidly increasing prices, supply shortages, lack of quality personnel, rising insurance costs and the "post-Enron" emphasis on accurate financial reporting. Accordingly, these problems have given rise to new managerial strategies as well as a re-emphasis on old strategies to address these "hot button" issues. Nationwide, the "best of class" contractors are addressing these issues and adapting their operations accordingly.

Price Increases and Supply Shortages

The impact of Hurricanes Katrina and Rita will be felt nation-wide by the construction industry. Even before the devastating hurricanes pounded the Gulf States, construction materials and supplies were becoming scarce and prices were rising rapidly. Global demands (mainly in China) on supplies of cement, steel, petroleum products, lumber and heavy machinery had put many regions on quotas and driven prices abruptly higher.

The hurricanes will only exacerbate the problem. Already, experts are estimating that the Gulf region reconstruction will require 30% to 40% of the U.S. lumber, steel and cement supplies, driving prices sky high. Furthermore, the short-term effect on gas, diesel and liquid asphalt prices has been shocking. In response, contractors should consider the following contract management procedures:

1. Bidding procedures and models should be immediately altered to consider the effects of higher prices. Long-term contract bids should allow for the probability that prices will continue to rise during the contract period. For example, some estimates indicate that fuel price increase since July 2005 have resulted in across the board increases in construction costs of at least 15%.
2. Insurance costs will undoubtedly rise. Extended period contract bids should consider higher insurance costs in labor burden rates and other costing components.
3. Consideration should be given to special contract clauses exempting the contractor from liquidating damages and delay claims resulting from uncontrollable supply shortages.

4. Contract bids should include price escalator clauses for dramatic jumps in petroleum, cement, steel and lumber prices. Many Department of Transportation contracts include price escalator clauses and other construction segments should follow suit.
5. Contractors bidding long-term contracts with significant quantities of materials, especially fuel and asphalt, should consider purchasing a commodity hedging or straddle contract.
6. Now more than ever, obtaining surety bonds for suppliers and subcontractors should be a mandatory control procedure. Due to the volatility of supply and price, the bid quote is only as good as the subcontractor or supplier.

Surety Industry Problems

In 2004, the surety industry reported record losses. The largest surety in the World, St. Paul Travelers reported a loss ratio of 142%. Almost every major surety reported losses in excess of their acceptable ratio. These losses, coupled with the reduction in available insurance capital caused by the hurricanes, are expected to tighten surety credit in 2006. To enhance their relationship with the Surety and the related re-insurance analysts, a contractor should implement the following:

1. Good communication is more important than ever. Consider an annual meeting with the Surety, the Banker, the CPA and senior management to discuss financial matters. Address continuity planning, backlog projections, cash flow, equipment budgets and financial benchmarks during the meeting. Sureties are concerned about price increases and supply shortages. Be prepared to discuss any significant exposure and the related control procedures implemented to limit risk.
2. Improve financial reporting. Provide Sureties with accurate internal quarterly financial statements and contract schedules. Use a CPA familiar with the construction industry.
3. Clean up your financial statements and avoid unhealthy practices. Eliminate underbillings and other soft assets. Use conservative contract estimates to avoid significant job fade.
4. Bid jobs that fit your niche in terms of size, type and geography.

Cost Plus Contracts

Cost plus contracts with a guaranteed maximum price are widely used. Most contracts have shared-savings clauses or similar incentives to control costs. The terms of these contracts generally grant the owners the right to audit costs within three years of the completion date. Any overcharged costs are reimbursable to the owner. The impact of cost overcharging is both to the bank account and the reputation of the contractor.

A key area in cost plus contract accounting is the definition of costs. Stipulated or standard costs are widely used to replace actual costs for such areas as labor burden rates, project management fees, equipment rental rates and similar costs. These stipulated rates are used primarily for convenience and consistency. With the exception of equipment rental rates, stipulated rates must approximate actual costs.

Many owners are hiring accountants (bounty hunters) to audit cost plus contracts. In light of the new emphasis on cost plus contract accounting caused by these audits, contractors should consider these control procedures:

1. Ascertain that all stipulated costs are adequately defined in the contract terms. For example, items included in labor burden rates should be listed along with the stipulated rate for each component. Equipment rental rates should be based on standard industry rates such as Blue Book Rates.
2. Self-performed work should be defined in the contract documents. Unless stipulated in the contract terms, self-performed work is subject to the actual cost plus the stated fee.
3. If self-performed work is treated as a “lump-sum” item and exempt from the cost plus requirement, contractors should be able to prove to owners that the amounts paid were competitive. Documentation should be retained to support that amount paid were competitive with subcontract quotes.
4. Project managers and estimators should be adequately trained to avoid inappropriate cost plus contract billing practices.
5. Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement, may require disclosure of contract overcharges and require communication to management by the contractor’s CPA auditor.

Cost Segregation

Tax depreciation is a hot button issue to contract owners and, accordingly, to contractors as well. Many contract owners incur significant fees for CPA’s and engineers to perform a cost segregation “study” on the newly completed building after construction is completed. For example:

1. The electrical cost of a non-residential building is depreciable over 39 years, but computer wiring is 5-years and light fixtures are 7-years.
2. Flooring is depreciable over 39 years, but carpeting is only 7-years.

Accordingly, the owner needs a detailed cost breakdown to maximize the tax depreciation. Contractors have discovered that providing this service to owners during construction has real value. In fact, the Contractor is in a position to provide a more accurate cost segregation breakdown than a post completion cost study. Many contractors charge a competitive fee for the additional cost to provide this breakdown. Others see this service as a “marketing tool” that can improve their chances of obtaining the contract.

Recent Accounting Rule Changes

In the post-Enron accounting world, a number of new accounting pronouncements have been issued. These requirements have required contractors to react accordingly in order to minimize their impact to financial reporting.

1. Financial Accounting Standards Board Opinion 150 (FAS 150) may require disclosure of significant liabilities related to buy/sell agreements. This disclosure is required if significant off balance sheet obligations have been created by stock redemption agreements that will effect the equity of the contractor. FAS 150 has been a wake-up call to revisit stock redemption agreements and modify terms that create a hardship on continuity. Contractors should review the post-redemption impact that the valuation and terms have on surety, licensing and prequalification.
2. Financial Interpretation 45 (FIN 45) has beefed up the financial disclosure requirements for off balance sheet financial guarantees. Contractors must consider accrual of liabilities and/or disclosure of financial guarantees related to warranties, self-insurance deductibles, non-bonded subcontractors, bid prices, non-cancelable operating leases and similar items.
3. Financial Interpretation 46 (FIN 46) requires the consolidation of all entities in the same group regardless of ownership percentages. Thinly capitalized affiliate entities that pose a risk of loss to their “Primary Beneficiary” must be capitalized under this interpretation. Contractors should consult with their CPA to determine the companies that must now be consolidated. The consolidation of certain entities may greatly affect the financial picture and, accordingly, impact bonding and banking relationships.

Electronic Fund Transfers

The world is moving towards electronic cash transactions and away from the traditional check writing process. While electronic fund transfers have many advantages over paper checks, the process is not exempt from potential fraud. Currently, all contractors make payroll tax deposits, income tax payments and state tax deposits using electronic transfers. Many vendors, contract owners and subcontractors are requesting electronic payment in lieu of checks. Many contractors use a direct deposit payroll system. It is imperative that contractors implement a system of internal control to limit the possibility of errors and fraud with the process. Consideration should be given to these control procedures:

1. Limit transfer powers to company personnel that are independent of the accounts payable process. Authorization should be in writing and controlled by password.
2. Independent company management should review the bank transfer statement monthly and trace transfers to authorized payments. Unrecognized fund transfers should be investigated.
3. Electronic transfers should be initiated in writing (email) instead of telephone authorization.

Summary

The next few years pose many challenges to American business and especially the construction industry. The economic effects of the recent hurricane disasters, international supply shortages, rapidly increasing prices and new accounting rules could be significant. The best contractors are on top of these hot button issues and, accordingly, have implemented the appropriate procedures to minimize their impact.

