

Cost Shifting – The Hidden Risk of Construction Accounting

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Executive Summary:

- Cost shifting is an accidental or deliberate misstatement in a contractor's job cost system that can have a substantial impact on the contractor's balance sheet and income statement.
- Both contractors and their auditors should be aware of the potential impact of shifts in job costs from one contract to another. The contractor should have a reliable job cost system in place to record contract costs accurately. The auditor should always test contract costs and look for unusual contract costing trends.

Recent headlines seem to be filled with corporations improperly booking assets related to uncompleted construction contracts. To the public, it seems improbable that a qualified auditor could simply overlook the improper capitalization of significant assets. However, traditional audit procedures designed without construction accounting in mind can fail to detect the improper booking of assets related to uncompleted construction contracts. Significant cost shifting can quickly cause a material misstatement to a contractor's financial statement and leave the contractor and the auditor open to serious charges.

Cost shifting is an accidental or deliberate misstatement in a contractor's job cost system that can have a substantial impact on the contractor's balance sheet and income statement. The most dangerous type of cost shifting involves moving or misdirecting job costs from an unprofitable job to a profitable job. Cash and accounts payable balances are unaffected. Accounts receivable and expense account balances are also unaffected. In many cases, however, cost shifting can have a balance sheet and income statement impact *larger* than the amount of the costs that have been shifted.

What is the Effect of Cost Shifting?

At first glance, the movement of costs from one contract to another would seem to have little or no overall financial statement impact. It seems improbable that a substantial misstatement of profits could occur without affecting any expense accounts. It also seems improbable that profits could swing without booking any additional billings. However, many contractors and their auditors have discovered the dramatic impact that cost shifting can have on a company's financial statement.

The example below shows the substantial gross profit impact of a \$200,000 cost shifting entry:

Contract A

Contract B

	<u>Completed Contract</u>	<u>Uncompleted Contract</u>
<i>Before Cost Shifting</i>		
Contract Amount	\$1,200,000	\$1,500,000
Estimated Job Costs	(<u>1,300,000</u>)	(<u>1,200,000</u>)
Estimated Profit	(<u>\$ 100,000</u>)	<u>\$ 300,000</u>
Billings to date	\$1,200,000	\$ 600,000
Overbilling (Liability)	<u>-</u>	(<u>100,000</u>)
Revenue to date	1,200,000	500,000
Costs to date	(<u>1,300,000</u>)	(<u>400,000</u>)
Gross Profit to date	(<u>\$ 100,000</u>)	<u>\$ 100,000</u>
Job percentage complete	<u>100%</u>	<u>33%</u>

After Cost Shifting

(\$200,000 of costs are shifted from Contract A to Contract B)

Contract Amount	\$1,200,000	\$1,500,000
Estimated Job Costs	(<u>1,100,000</u>)	(<u>1,200,000</u>)
Estimated Profit	<u>\$ 100,000</u>	<u>\$ 300,000</u>
Billings to date	\$1,200,000	\$ 600,000
Underbilling (Asset)	<u>-</u>	<u>150,000</u>
Revenue to date	1,200,000	750,000
Costs to date	(<u>1,100,000</u>)	(<u>600,000</u>)
Gross Profit to date	<u>\$ 100,000</u>	<u>\$ 150,000</u>
Job percentage complete	100%	50%
Increase in gross profit	<u>\$ 200,000</u>	<u>\$ 50,000</u>

In this example, Completed Contract A improves by \$200,000 due to the costs shifted off the job. However, Uncompleted Contract B also improves because the contract is now 50% complete rather than 33% complete. Because Contract B is uncomplete, gross profit is recognized on the percentage of completion basis. Therefore, Contract B recognizes 50% of the estimated gross profit for the entire job (\$150,000) rather than 33% of the gross profit for the entire job (\$100,000). The \$200,000 cost shifting entry improved the books of the contractor by a total of \$250,000.

In this example, Uncompleted Contract B received \$200,000 of costs which did not belong to that job. When Contract B is completed, it will either finish \$200,000 over budget or another cost shifting entry will occur.

Who Benefits from Cost Shifting?

Although the big corporate cases grab the headlines, most cost shifting does not occur when a corporation tries to manipulate its balance sheet. Cost shifting occurs most frequently when field level managers attempt to manipulate contract profitability. Cost shifting can also happen accidentally although the consequences usually are not as severe.

Contractors often pay bonuses to their field managers and estimators based on the profitability of completed contracts. In the above example, the estimator of Contract A might receive a bonus based on the false assumption that the contract was profitable. Or, the superintendent of Contracts A and B might deliberately miscode invoices from one job to another to hide losses that occurred under his supervision.

How to Spot Cost Shifting

The only way the contractor's balance sheet changes when cost shifting occurs is that underbillings (an asset) increase and overbillings (a liability) decrease. Underbillings should be rare, especially in contracts over 50% complete. Auditors and other users of contractors' financial statements should look at underbillings skeptically and investigate each underbilling carefully.

Many users of contractors' financial statements prepare fade schedules. A fade schedule measures a contractor's job profit forecasts versus the final profit on a job. At a minimum, significant contract fades can indicate poor job profitability forecasting. At worst, contract fades can indicate cost shifting has occurred.

Traditional audit procedures designed for non-contractors will not detect cost shifting. Tests designed to search for unrecorded liabilities or to detect improper cutoff of expenses will only reflect that all costs have been reported in the proper period. Tests designed to find improperly booked billings or receivables will find no exceptions. Audit test work for cost shifting must focus on the accuracy of job costing procedures.

Controls and Audit Steps Designed to Detect Cost Shifting

Intentional cost shifting constitutes fraud by some member of a contractor's management. While audits are not specifically designed to detect fraud, an auditor must test contract costs and internal control systems. The following steps are designed to prevent or detect cost shifting:

1. *Strong internal controls for job cost coding* – Project managers should not have free reign to code job cost invoices without accounting review.
2. *Restrictions over job cost journal entries* – A log of all job cost entries should be maintained. Entries should never be prepared by field personnel or superintendents. Auditors should always review job cost journal entries made by management. These journal entries should be tested for appropriateness and accuracy.
3. *Test Job costs for accuracy* – At a minimum, every audit of a contractor must include random testing of contract costs and the related cost coding. The most significant components of the contractor's job costs should receive the heaviest scrutiny.
4. *Compare job costs against bid documents* – Every contractor should estimate contracts in the same manner in which they record job costs. An auditor should test job costs for significant contracts by comparing each line item of job cost against the original forecast. Any overruns should be explained and, preferably, documented with a change order.
5. *Test revised profitability estimates against bid documents* – Very often, cost shifting is accompanied by an upward revision in contract profitability. This actually makes the financial impact of the cost shift even more drastic. An auditor should test revised profitability estimates against original bid estimates in the same manner in which job costs are compared against bid documents. Cost shifting by field personnel can also involve directing a subcontractor to invoice the wrong contract. Comparison of subcontract costs on particular line items versus the original bid amount can help spot this type of cost shifting.
6. *Analytically test job cost components* – Contractors who perform similar types of work should have comparable costs from job to job. For instance, a grading contractor whose overall direct costs are 40% equipment related should have about the same percentage of equipment costs on each job.
7. *Review allocations of indirect job costs* – Cost shifting is often hidden in the allocation of indirect costs such as internally-owned equipment costs, shop costs, insurance, and labor burden. Periodic tests should be performed to ensure that each job is being charged its fair share of indirect costs.
8. *Perform a fade analysis* – The best contractors tend to finish jobs at the same profit levels at which they were forecast. Two fade schedules should be prepared. The first measures each job's prior period profitability forecasts against current forecasts or actual results. The second schedule should restate prior period uncompleted

contract schedules using revised profitability figures. Each of these schedules helps an auditor determine which contracts have had unusual fluctuations in profits.

9. *Examine bid spreads* – Examining bid results can help an auditor determine whether a contractor has been awarded a job at an unusually low price. The auditor should compare the contractor's bid price versus the second place bidder and versus the average bid price of all the contractor's competitors bidding for each job. If a contractor is more than 5% to 10% low on a job, the contractor will likely make little or no profit on that job. Such a job is a prime target for cost shifting.
10. *Compare profitability estimates against historical results* – A contractor may attempt to hide cost shifting by increasing profit estimates on uncompleted jobs. When this occurs, the gross profit percentages on uncompleted jobs will often exceed the contractor's historical results. Another test for this would be to compare uncompleted contract gross profit percentages with completed contract percentages.

An Ongoing Process

Both contractors and their auditors should be aware of the potential impact of shifts in job costs from one contract to another. The contractor should have a reliable job cost system in place to record contract costs accurately. The auditor should be careful always to test contract costs and look for unusual contract costing trends.