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Some aspects of accounting for the construction industry

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Some Aspects of Accounting for the
Construction Industry

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After reviewing the earnings statistics of your industry that you have before you and listening to Mr. Knutson's remarks regarding the state of the construction industry, I hope you are not looking to me for all the answers to your problems. There is no doubt in my mind, however, that accounting is essential to every contractor, and many of the difficulties encountered are directly attributable to the lack of reliable accounting information. I would like to caution you, however, that accounting is the means to an end rather than the end itself; merely providing a good accounting system will not solve your problems unless management makes intelligent use of all information and data made available. Accounting is only a tool of management and unless management becomes skilled in the use of the information supplied by its accounting department full value will not be derived from such information.

Since Mr. Leck will have a lot to tell you on cost control and management use of accounting data, and since he speaks from the background of long and successful experience, I will direct most of my comments to the general aspects of accounting in the construction industry. In the remarks that follow I have drawn upon the material in a publication of the American Institute of Certified Public Accountants entitled Generally Accepted Accounting Principles for Contractors. This is an excellent booklet and it would be well worth your while to read it.

First, let me say that there is no such thing as a standard accounting system for your industry. There are many similarities in the operations of different construction companies, but a successful system must be tailored to the individual situation. A good accounting system, while it will not guarantee profits where the bid is too low, will help direct your attention to areas where economies may be possible and thereby often enable you to salvage something from an otherwise unfortunate bid.

As a bare minimum, the accounting system must provide the
necessary figures to prepare the financial statements, such as the balance sheet and income statement, demanded by your banker and surety agent. Only the smallest firm should be satisfied with such a minimum. An acceptable system should also enable a contractor to compare his actual costs on jobs with his estimates and should provide costs for each contract that are broken down into material, labor, and sub-contracts. As a further refinement, it is probably desirable for most of you to know your contract costs by items of work, such as excavation, foundation, masonry, carpentry, etc., to permit a detailed comparison of actual costs with bid costs. And let me emphasize again that only by intelligent use of all available information can you hope to improve your operating results, and the more detailed your information, the more definitely can you determine your weak points and take remedial action.

As all of you know, there are two basic methods of accounting—the cash basis and the accrual basis.

As its name implies, the cash basis recognizes income and expenses only as actually received and paid. There is not much to recommend this method except that it is simple. It is so obviously unsuited to the construction industry that if any of you still use such a system, I recommend that you immediately consult your CPA and have him install an accrual system which matches income with related costs and expenses and will provide meaningful and reliable accounting information.

Even if you have a good accrual system of accounting you still have the problem of choosing the proper basis for taking into earnings the billings on your contracts. Here again, there are two commonly used methods—the completed-contracts method and the percentage-of-completion method. The choice between these methods is governed principally by the type of contracts usually performed.

When contracts are of short duration, from a few days to a few months, the completed-contract method should be used because of its simplicity.

When contracts are of long duration and the contractor's accounting system and engineering and estimating are dependable, the use of the percentage-of-completion method will undoubtedly give more realistic income figures. However, there are so many inherent risks under the percentage-of-completion method, that unless the contractor's costs and estimates are thoroughly dependable, it probably would be desirable to use the completed-contract method.
The completed-contract method recognizes income only when a contract is completed. During the period of construction, billings and costs are accumulated, but no profit is recorded until the work has been substantially completed. The principal advantage of this method is that it is based on results as finally determined rather than on estimates. Its disadvantage is that it does not reflect current performance when a contract covers more than one accounting period, and therefore tends to bunch income in the year of completion of the contract.

The percentage-of-completion method, on the other hand, recognizes income as work on contracts progresses. Income under this method may be recorded on the basis of the ratio of actual costs to date to total estimated costs under the contract. Any other method that properly reflects the percentage of completion of a contract could also be used, but care should be exercised in the choice of any alternate method. Under percentage of completion it is, of course, necessary periodically to adjust the total estimated cost of the contract as actual experience indicates the original estimate to be too high or too low.

Under either the completed-contract or percentage-of-completion method, conservative accounting demands that immediate provision be made for any losses whenever current estimates of completion costs indicate that a loss may be incurred.

So much for the broad general aspects of construction accounting. Now I want to say just a few words about more specific items.

**CONTRACT COSTS**

Every accounting system worthy of the name should provide for the accumulation of costs by individual contracts. These costs should be as detailed as possible. I am not going to attempt to be specific concerning what information the contract ledger should contain, as this subject will be covered later by another speaker. I do wish to impress on you that accounting for contract costs is the most important side of any contractor's accounting setup as it provides the data most needed by management to control and guide its operations. It goes without saying that all of you should review your contracts in progress periodically, daily or weekly if your records permit—certainly at least once a month.

Your review at a minimum should include:

- Comparison of actual costs incurred to date plus estimated
costs to complete (however sketchy these estimates may be) with the original estimated costs and an explanation should be obtained for any material variations

- Comparison of the actual billings with the terms of the contract to assure that bills are being rendered promptly
- Review of contract charges for the use or rental equipment on contracts
- Review of the application of supervision and overhead to individual contracts
- Review of the basis of recording income if the percentage-of-completion method of accounting is used, to be sure the method used actually measures contract completion

PAYROLLS

Payrolls are such an important part of the construction industry that the frequent employment and layoff of men makes it imperative that extreme care be taken to avoid irregularities such as payroll padding. There should be a well-defined procedure for adding men to the payroll and for their separation. If your operations are extensive, an occasional pay-off should be made by accounting or administrative personnel to assure that unauthorized names have not been added to the payroll.

Attention should also be given to the distribution of payrolls to assure that charges are being currently made to the contracts in progress, and that all time spent on a job is actually charged to the job. Payroll taxes and fringe benefits should be charged on the same basis as the payrolls.

MATERIALS AND SUPPLIES

The contractor should have a good system for charging out warehouse materials to the job, and for charging materials purchased for a specific contract. This might seem elementary, but I have seen so many instances where substantial inventory adjustments were necessary that I feel justified in mentioning the matter at this time.

The contractor must also be careful not to include excess materials purchased for a specific contract in his inventory unless he is certain such materials will be usable on subsequent contracts in the near
future. Obsolete and inactive materials in the inventory may lead to subsequent losses when such losses can ill be borne.

ACCOUNTS RECEIVABLE

Prompt billing in accordance with the terms of the contract seems obvious, yet we often find cases where a contractor is pledging his receivables while many contracts remain unbilled. Constant attention to billing procedures will save many a contractor sizeable amounts of interest on unnecessary borrowing, and ease credit matters materially. Vigorous collection efforts on bills rendered will likewise have the same effect.

I could continue with other matters that should have your attention, but my allotted time does not permit. However, I should like at least to make clear what I consider to be the accounting areas that most frequently contribute to the failure of contractors to achieve financial success:

- Failure to periodically evaluate contract profitability on a realistic basis and to take remedial action
- Inadequate control over estimating and bidding
- Inadequate contract cost records
- Weaknesses in billing procedures
- Poor control over payrolls and over materials and equipment on job sites

While profits depend primarily on proper bidding and good execution of contracts, I am certain that reasonable consideration of the points I have touched upon will render a valuable assist in making your business more profitable.