

Making the construction industry accountable

by Felix le Roux

The success of a construction firm is closely aligned to and determined by its ability to forecast and control costs – functions that have accounting as their base. The construction industry has a history of neglecting to perform the accounting function properly. The problem is either related to the nature of construction accounting itself, or to the way financial reporting is done in the construction industry.

In a construction entity, one would expect to find a variety of built environment and accounting professionals. It would be logical to assume and expect these professionals to use methods and systems that are mutually compatible to ensure effective and accurate information sharing. This perception is not, however, backed by feedback from the industry.

Why does the construction industry experience accounting problems? The answer could be all, or some of the following:

- The accounting education of built environment professionals is not up to standard, or the standard required has not yet been established or is misdirected.
- The accounting education of built environment professionals is passed on to the accounting departments of those institutions. Business schools teach the fundamental principles of financial management to students, but the unique characteristics of the construction industry render the usefulness



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of these teachings almost meaningless.

- Contractors do not spend as much time, energy and resources on the financial management of their businesses as they do on operational management.
- The design of the accounting system for a construction entity is left to the accountant.
- The situation might exist where accountants and contractors do not communicate with sufficient clarity to avoid ambiguity and costly mistakes.

The following questions therefore arise:

- Do external auditors and accountants draw up financial statements without any assistance from built environment professionals?
- If there is no such assistance, where do accountants acquire the skills needed to measure and estimate to enable them to audit items such as cost to complete on a construction contract?
- If built environment professionals know, at best, little or nothing about accounting principles and guidelines and the impact thereof on their financial statements, are they able to assist in compiling financial statements?
- Do accountants share the opinion of built environment professionals that one needs to measure before one can estimate?
- Do registered auditors and accountants 'rely' on the work of an expert when needed, considering that such reliance is not allowed in accounting practice?
- Will financial statements compiled by external auditors and accountants and those compiled by internal accountants be similar in principle and specifics?

The major accounting problem facing a contractor is the determination of "an equitable method of revenue and costs allocation" and failure to do so adequately can lead to profit manipulation. The longer the duration of the contract, the greater the problems

surrounding profit recognition. Critical to this allocation is the ability to determine the percentage of completion of the contract and the cost to complete at the reporting date. The important activities in recognition in this regard are to reliably measure, estimate and identify the revenue and costs associated with the contract.

Both the percentage of completion and the cost to complete can present problems. Lack of good accounting records can prevent the establishment of costs to date and have a major impact on calculating the percentage of completion on the contract. Many construction firms cannot give an accurate estimate of such costs. The estimate of cost to complete is the most critical element in accounting for revenue and unbilled receivables under long-term contracts and evaluating the need to provide for estimated losses. The need to do estimates undermines the quality of the profit reported.

Construction companies using the percentage-of-completion method of accounting are one of the more challenging situations in audits. Such businesses depend on accurate and reliable estimates to operate their businesses and to prepare financial statements in accordance with generally accepted accounting principles. It is critical for the auditor to gain an understanding of the contractor's significant estimates and assumptions in operating his business.

Methodology

A questionnaire containing 66 questions with subquestions (amounting to 142 questions in total) was sent to the registered auditors and accountants of general contractors.

The term *general contractors* is normally an indication of the size of the contractor's business, the duration of contracts, internal control and internal accounting knowledge and expertise. The external professional's consistent application of guidelines and knowledge of accounting principles in general were the most important aspects in this decision.

The questions were structured around the basic principles raised by issues such as the following:

- Do accounting guidelines provide clear and feasible guidelines to determine the stage of completion of a construction contract for disclosure in the financial statements of contractors? Are 'reliable measurement' and 'reliable estimates' clearly identified as the most fundamental concepts, and are they clearly defined?
- Do the terms 'reliable measurement' and 'reliable estimates' refer to the mathematical correctness of calculations, or do they refer to the use of special skills and experience of specific professionals? Can each of the alternative methods of calculating the stage of completion only be used in a specific set of circumstances, or in any given set of circumstances?
- Do the prescriptions and guidelines in 'using the work of an expert' provide an adequate alternative for gaining audit evidence to verify calculations and estimates of work in progress and the stage of completion of construction?

Results

Respondents were in general agreement that the most important concepts contained in the accounting guidelines were contract revenue, contract costs and the recognition of revenue and expense.

Respondents did not appear to doubt that they did not possess the skills needed to perform the required tasks. They believed that senior accounting-orientated personnel could perform the verification of the measurement that was normally done by the built environment professionals.

Indications were that the preferred method for calculating the stage of completion is 'costs to date', compared with 'total expected costs'. Whether the method for calculation was a free choice, or whether any specific prescriptions were applicable, proved to

be inconclusive. The requirement is that the enterprise uses the method that reliably measures the work performed. The built environment professionals would expect this to result in a 'surveys-of-work-performed' method.

Auditors did not indicate any need for outside assistance to conduct construction audits.

Conclusion

In order to apply the percentage-of-completion method of recognising revenue and costs to construction contracts, it must be possible to reliably estimate the outcome of the contract. Reliable estimates depend on reliable measurements. Built environment professionals would deem it logical that the process starts with measuring, progresses to estimating and ends in cost recognition.

Ambiguities exist as a result of the choice of words, principles and actions contained in accounting guidelines. These may be more problematic for the contractor and his internal accountant than they realise. They are confronted with seemingly familiar phrases that actually have different meanings and expect different outcomes. The guidelines refer to the accountants' interpretation and definition of words common to both professional groups.

The mere fact that certain respondents differed or were unsure on certain issues, verifies the assumption that some confusion exists. From the survey, it appears that problems in construction accounting and reporting could arise due to the fact that certain guidelines and terms are not consistently interpreted by all involved. 📍

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