Basic principles for Construction accounting

What questions should be asking when considering an Accounting System unique for Construction

The preparation and management of Construction Accounting is fundamental to an organization wanting to manage its operational costing on a day to day basis.

Certain factors must come to mind when researching the right accounting system for your construction company.

1. **Does your accounting system all for multi-year projects during the financial year audit.**

   Traditional accounting systems consist of a statement of Income and Expenditure, made up of \[\text{Sales} - \text{Cost of Sales} = \text{Gross Profit} - \text{Overhead Expenditure} = \text{Net Profit}\] and the Balance Sheet is used to balance out all Income Statement accounts which are the trading accounts. At the end of each and every financial year, the Net Profit figure is then transferred the Balance Sheet and the Income Statement figures are zeroed, ready for the subsequent year’s figures.

   This is a fundamental problem in construction. Clearly, construction projects extend over the end of financial years, and these figures *cannot be cleared* without noting the profit/loss position of each of the projects still underway. Therefore a construction accounting system must recognize this need and insure that this calculation is natural and reliable.

2. **Does your Accounting Systems have specialized ledgers to accommodate unique construction requirements**

   Investigate your accounting system for specialized ledgers within the system to address problems unique to the construction industry. Examples of these specialized ledgers are:

   A. **The ‘Contract Ledger’:**

      In Construction (assuming the organisation’s main activity is restricted to normal construction) the Sales figures relate mainly to Project/Contract Revenue, and the Cost of Sales figures would relate to the cost of all resources utilised in the course of construction. The ‘Contract Ledger’ is purpose built to clearly identify and track all the Revenue and Cost elements associated with each project/contract.

      i. The Profit/Loss (Gross Profit) figures reflected in the books of account for the construction operations are also subject to international accounting standard (IFRS, IAS-11) that dictate how profit/loss is to be recognised, and mostly does not equal \(\text{Sales-Cost of Sales}\), but is based on the percentage complete of each project [IAS-11.22].
ii. Should the Income Statement be cleared year on year, there would be a great deal of difficulty determining the project completion percentage especially if the project extends over a number of financial years.

iii. Percentage complete relies on the fact that the final estimated cost, as well as the final estimated revenue of the project needs to be estimated for the financial year in question, an accurate assessment of the actual cost of construction to date be determined, and only then can an assessment be made of the percentage complete.

B. Does the accounting system have an Overheads Ledger or Plant Ledger?

The determination of total project cost entails the detailed tracking of all cost elements, as the percentage complete figure that will be determined, relies on the accurate recording of these values. A number of cost elements (plant and equipment, workshops, internal repairs,...) are internal costs, and although they do not affect the Net Profit figure, they have a substantial impact on the Cost-to-Date, and therefore the Profit/Loss.

The accounting system needs to take account of these internal costs to provide operational and management accounting figures to the likes of the Plant Manager, and Workshop Manager. Life-to-Date cost data on plant and equipment is imperative for effective plant and equipment management and cost control.

3. Does the Accounting System integrate the Accounts ledger with Project Management reporting

To determine the Profit and Loss by project for Management Reporting (outside the financial books of account) project personnel do not rely on the determination of profit/loss according to the IFRS standards, but do so using the Gross Profit figure. This forces the organisation to manage their accounts in two ways - which necessarily leads to a potential conflict between project management and accounting reporting.

However, project managers are bound by the revenue figures determined by the monthly valuation, and need to report on profit/loss as it relates to measured work. Project management reporting, therefore, is not compatible with accounting reporting and adjustments need to be made.

Check that the accounting system cater for the IAS-11 specifications which provides an important advantage when this is recognized by the chief financial officer.

4. Does the accounting systems recognize the method to compare Actual to Allowable (Budget).

Budgeting is normally confined to a budget forecast of the cost elements in the overhead expense listing, with a singular estimate of sales, and cost sales, over the coming financial year. This is based on similar figures, after some adjustment, of the previous year values.

Construction budgets and forecasts often cannot work in this way. Certainly office overheads may, but Project/contract budgets not. Construction budgets (allowables) are
calculated from work done on a monthly basis. Construction accounting therefore requires that the construction budget is produced from a valuation of the work done from the source document i.e. Bills of Quantity.

Next, the comparison of actual cost and cost budgets (allowables) needs to occur at a particular point in time, normally towards the end of the month and generally before the books of account for that period have been closed. It is important for an accounting system to provide a ‘snapshot’ of actual costs at a particular time in order to make possible comparison with the cost budgets.

5. **Does the accounting system have features to control cost through from the Estimate through Procurement to recognition of cost as materials are delivered and paid for.**

Procurement for construction must be based on the determination of the quantity and cost of the individual resources used in the determination of the net cost of each work item in the Bills of Quantity.

Therefore procurement of resources is constantly being re-modelled over the life of the project and is constantly under review as a result of the provisional nature of the quantities of work performed.

As the quantities change, so will the allocation of resource usage and cost on the project. The procurement of goods and services needs to be measured against the items procured in terms of quantity, as well as their monetary value. Therefore, both quantity and value is of importance here as the budget is dependent on both these indicators.

The request for quote from Suppliers and Sub Contractors needs to take place within the framework of the estimate of work (Bill of Quantities) to be performed and is directly related to the estimated Bills of Quantity resources rates. Without this, there is no real basis for comparing real cost with estimated cost at the outset, or during the life cycle of the project.

The procurement process necessarily leads to the **accrual** of cost information on a daily basis as a result of the delivery of requisitioned and ordered goods and services. The system is required to track the movement of delivered goods throughout the costing as well as the accounting cycle in order to reconcile the final figures back to the books of account. Sub Contract procurement and change order procurement must also form part of this process.

6. **Does the accounting system provide features for Sub Contract management**

Sub Contract management, related to the detailing of the reconciliation of sub contract measured work, advances, M.O.S., variations, contra costing and other accounting entries related to each certificate, is a varied and often complex set of functions and is a critical element in Construction accounting practice.

7. **Does the accounting system provide tools for Stock Management**
The design of Stock Management systems for construction projects is generally vastly different from standard systems. Stock movements take place between site stores on a continual basis unlike static setups. Stock is procured from project buying lists, for plant & equipment directly, or via job cards for repairs and maintenance. The combination of different stock transactions in this scenario is very varied and unlike any standard accounting stock system.

Also, the stock management system has to take the accruals nature of project costing into account.