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The Numbers Game: Construction Finance and Accounting

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I) **Importance of understanding financial accounting issues**

In this paper, we will explore some of the basic accounting and finance concepts that are often important to construction attorneys and other professionals. In our view, the importance of these concepts can be several-fold, including their use in:

A) *Establishing contract amounts*

In many contracts, including cost-plus GMP contracts, financial and accounting terms are used to calculate the amounts due to a contractor. In some cases, contract terms state that the parties will default to costs in accordance with GAAP (Generally Accepted Accounting Principles), so an understanding of some basic GAAP concepts is important. Other examples exist, including terms like accrual-basis accounting, job-cost records, etc.

B) *Defining aspects and reports/documents necessary for change-order support*

Once a contract starts, and change orders are requested by an owner and/or submitted by a contractor, reference will be made to items such as overhead rates, G&A (general & administrative expense) rates, job-cost reports, accounts-payable records, labor-distribution reports, etc. Assisting a client with these issues requires familiarity with the concepts being referenced.

C) *Claim evaluation and litigation*

As with the change-order process, if change orders become requests for equitable adjustment, develop into claims, or lead to litigation, the concepts discussed above are even more critical due to the disputed nature of the items at issue.

D) *Determining the financial strength or weakness of an entity*

As part of entering into a contract, it is often important to assess the financial viability of an entity. Payment terms and oversight might be driven by the strength or weakness of someone’s financial statements. In fact, the decision as to whether or not to contract with a given party may
be based on such an assessment. Therefore, it is important to understand basic financial ratios and reporting to make sure a sound assessment of strength or weakness is being made.

E) Developing owners’ counterclaims due to delays caused by contractors

Many contracts grant owners remedies against contractors for late completion or improper performance beyond liquidated-damages provisions. When pursuing claims for lost profits or extended management/oversight costs, an understanding of the entity’s financial statements can become critical.

For many lawyers, there is a natural tendency to shy away from many accounting and financial topics. Lawyers often prefer to focus on legal and business topics that are more in the nature of challenging legal principles and research, and are not experienced or educated in the world of accounting or finance. This is true for lawyers who focus their practices in different areas of the law, including those involved with the construction industry.

As part of the ABA’s recognition of this condition, the Forum on the Construction Industry (now the Forum on Construction Law) published a book in 2010 entitled Construction Accounting – A Guide for Attorneys and Other Professionals. This book includes eleven chapters of financial-based and accounting-based discussion from legal and accounting professionals involved with the construction industry. It covers topics ranging from Basic Accounting and Financial Concepts to Claim Pricing, Audits, and Government Contract specific pricing issues. This publication is a good resource for practitioners wishing to explore further the accounting and finance topics peculiar to the construction industry that are discussed more summarily as part of this paper.

II) Problematic accounting and damage areas involving accounting and financial concepts

In the construction industry, there are certain elements of incurred costs, accounting conventions, and approaches to damages that often result in disputes between parties when
negotiating change orders, claims, or contract close-outs on projects. The following discussion addresses some areas where a fundamental knowledge of key accounting and cost concepts is critical to being able to successfully address issues that may arise.

A) *Home-office-overhead costs (G&A costs)*

Home-office overhead costs, often referred to as General & Administrative, or G&A costs, represent the costs incurred at the home office or branch office of an organization that are not specifically identifiable with a particular project. These costs include the costs of the corporate officers and administrative-support personnel, including corporate, accounting, marketing, information-technology, and human-resources personnel. The key distinction for determining a cost to be G&A is that it is typically a cost that is not “direct,” in the sense that the cost is not incurred at the field level or identifiable solely with a particular contract. It is not to be confused with field-office overhead costs, which are also of a support nature, but which are incurred in the field for a particular project. The field-overhead costs include the project manager, field superintendents, project accounting personnel, office trailers, pick-up trucks, etc.

In some smaller companies, certain of the costs that are typically viewed as field-office overhead are, instead, reported on the financial statements of a company as part of its G&A costs. Although this is not necessarily problematic from a reporting standpoint under GAAP, it does become a challenge in a claim situation since it is necessary to try and carve out, or allocate, some of the home-office G&A costs that are more in the nature of direct field-overhead costs. This is especially true if there are contract provisions that permit, for instance, field-office costs to be treated as direct and reimbursable, yet treat the home-office costs and profit as a mark-up to be applied to the costs of the change order or claim.

Please refer to Attachment No. 4 for an example of a detailed income statement with G&A costs.
Some of the other specific issues that arise in the area of home-office overhead are discussed in more detail in Section 6, below.

B) Field-office overhead (FOO or GC costs)

As part of the costs of performance for a project, a construction company incurs certain support-type costs that are not specifically identifiable with a particular element of work (e.g., concrete, steel, excavation, etc.). These costs are referred to as field-office overhead (FOO) or general conditions (GC) costs. GC costs include the project manager, site trailers, superintendents, on-site accounting and other administrative personnel, telephones, vehicles for field-office personnel, and other support-type costs. These costs are typically bid on a time-related basis, although there are certain “one-off” costs that are estimated in addition (e.g., move-in mobilization, demobilization, specific engineering support, deposits or up-front payments for utilities, etc.). In many contracts, there are provisions that allow for a mark-up to cover the GC costs, and sometimes that mark-up is inclusive of G&A costs and profit. Therefore, when a change order or claim arises for extra work or delay, some of the questions that arise are:

1) Are the costs being claimed for the delay period truly of a time-related nature, or are they one-time costs that would have been incurred in any event?

2) What period should be used to calculate a daily rate? If the delay occurred during the pre-mobilization period, should that period be used to compute the daily rate, since there was a comparatively lower FOO daily rate for that period, and using an overall-job rate would be inappropriate?

3) Has the contractor already recovered, as part of a mark-up rate or with specific GC costs included in change orders, certain amounts of GC costs for the same period as being claimed for delay? If so, how is the amount of the potentially duplicate recovery best calculated?
4) If some personnel costs are not charged to the job in the job-cost report and are not supported by timesheets, but recorded at the home office, are they recoverable in a delay claim? If so, how are they estimated/calculated?

5) Are there contract provisions that preclude any costs incurred at the home office that are otherwise specifically identifiable with the project (e.g., part-time accounting support where the accountant has contemporaneously recorded his or her time to the job)?

C) Equipment pricing

Equipment-pricing issues in the construction industry are both common and complicated. In some situations, to determine the cost for the usage of a piece of construction equipment for a particular day, week, or month requires complex cost-accounting allocations and assignments. Trying to calculate the “actual” costs for a given company and a given piece of equipment for a given timeframe can require complex cost-accounting allocations and assignments to arrive at an amount that is “precise.” However, often such precision is not possible, as many of the equipment costs are estimates and can change over time. Such equipment costs include depreciation (which is an estimated periodic charge that is driven by the asset’s estimated useful life), major repairs (which might not happen for a number of years and then occur all in one period), and facilities-capital-cost of money (COM). For that reason, many contracts default to the use of published equipment-use manuals (e.g., the Blue Book, the Army Corps of Engineers (COE) rate manuals, etc.), and specify their use for extra work or claims. For a lawyer working in the industry, it is important to be aware of the various sources for equipment-rate pricing and the differences in the various rate manuals that are published.

Additional key issues that come up in claim pricing include:
1) Should the contract stipulate a rate for idle equipment (along with a definition of what idle status constitutes)? If so, how should it be computed (e.g., 50% of the ownership portion of the rate; in accordance with the particular rate manual, such as 50% of depreciation plus COM as outlined in the COE manuals, etc.)?

2) In a delay situation, should the contract stipulate if the equipment or categories of equipment (e.g., superintendent vehicles, support cranes, etc.) are included in a daily rate for the period of the delay?

3) If the contract calls for the calculation of actual costs instead of a reference to rate manuals, should the contract include more direction as to how to calculate the actual costs?

4) If a company has a system of internal rates whereby it charges jobs from a central equipment pool for the use of the equipment, and it uses such rates to bid and bill jobs (with the resulting charge reflected on the company’s job-cost ledgers, should these rates be used (with or without modifications for over-recovery or under-recovery at the home office central equipment pool)?

D) Labor inefficiency

Although this paper is not intended as a comprehensive analysis of the concept of labor inefficiency, it is important to focus on the accounting and reporting aspects of construction companies that impact claims for labor inefficiency. These claims are often referred to as lost-productivity claims. The success of such claims often depends on how robust the accounting system and reporting capabilities are for the labor costs on a project. If a company merely accumulates labor costs in total, and then attempts to pursue a claim based on a total-cost or modified-total-cost approach, they will generally have difficulty in prevailing on lost-productivity claims.
Given the advancement and availability of computer applications, even smaller companies can now collect data at a level considered unprecedented as little as ten years ago. However, it requires a level of corporate focus and follow-through to make sure that the systems (and people) are in place to collect the data necessary to produce the productivity and performance results to support comprehensive-lost-productivity claims.

E) Termination/total-cost claims

Many contracts have provisions permitting an owner to terminate the contract for its convenience. In those situations, the provisions often call for payment of the contractor’s actual costs of performance up to the termination date (with other provisions that address completed items of work and profit/margin, etc.). In a termination situation, it is critical to understand what it means when the contract calls for “actual costs,” especially in situations where the contract is silent on many of the specifics of job-costing and reimbursable/non-reimbursable costs under the contract. Sometimes, the contract refers to costs in accordance with GAAP, or based on accounting standards and conventions. Thus, an understanding of the scope and limitations of such standards and principles is critical to the formation of these claims and an owner’s assessment of them.

F) Loss-of-bonding-capacity claims

Sometimes, a contractor submits claims for delays and changes that are so disruptive to its operations that they hamper its ability to bond new projects. In some rare cases, the delays and changes cause the contractor to go out of business. Claims for lost profits on existing and future work are then put forth. Past and projected financial statements are often used as the baseline for projecting these losses. Again, an understanding of the company’s reporting and accounting systems is critical to understanding and evaluating these claims.
In the next sections of this paper, we will review some of the basic financial statements and types of accounting records that support and influence decision-making with respect to basic financial and accounting issues.

III) Financial statements and CPA involvement

A) Financial statements

Financial statements are integral for reporting the financial results of a company over time or at a point in time. The three primary financial reports that are used to assess a company’s financial position and performance are the Balance Sheet, the Income Statement, and the Statement of Cash Flows. Many elements go into each of the financial statements, and those will be discussed in more detail later. Perhaps as important as the referenced financial statements are the Notes to the Financial Statements. As discussed further, these Notes include explanations of key issues that help effect and explain the numbers on the Statements. Included in the Notes are explanations as to things like key accounting conventions used for revenue recognition, bank note details, asset detail and depreciation methods incorporated into the financial statements.

B) Balance sheet

The Balance Sheet is a snapshot of what an entity has as of a particular date. Its components consist of Assets, Liabilities and Equity. Assets are what an organization owns or has title to. Examples are cash, accounts receivable due from customers, inventory and property. Liabilities are what a company owes to third parties. Examples are accounts payable to vendors, bank loans, and taxes. Equity represents the residual interest in assets after liabilities have been deducted. If a company liquidates all its assets and liabilities, what is left could be distributed to stockholders, and is referred to as equity. Equity is also referred to as net worth or book value.

Please refer to Attachment No. 1 for a simple example of what a Balance Sheet might look like for a company.
C) Income statement

The Income Statement shows the revenues and expenses of an entity for a specified period of time (unlike the Balance Sheet, which shows a snapshot as of a certain date). The components of an Income Statement include revenues, cost of revenues, gross profit, G&A, and other expenses or income such as interest and tax, and net income. The titles of some of the elements of an Income Statement will vary from company to company and within different industries, but there are some categories that are commonly used.

Please refer to Attachment No. 2 for an example of an income statement.

D) Statement of cash flows

The statement of cash flows shows the inflows and outflows of cash for the given period. It separates the sources and uses of cash according to cash received or spent from normal operations, cash received or spent from investments, and cash received or spent from financing activities. Careful analysis of the statement of cash flows, especially over time, can be a good indicator of a company’s ability to sustain its operations with the resources available.

Please refer to Attachment No. 3 for an example of a statement of cash flows.

E) Independent CPA’s and financial statements

Companies often engage an independent Certified Public Accountant (CPA) firm to report on their financial statements. There are basically three different levels of engagements or reports: audit, review and compilation. Each has a different level of involvement by the CPA firm. A lender, shareholders, or a bonding company will typically require that a company engage an independent CPA firm to audit or review its financial statements as a part of the loan or bonding commitment.

In an audit, the independent auditor issues an opinion on the financial statements and whether or not they are in accordance with Generally Accepted Accounting Principles (GAAP).
The audit is performed under Generally Accepted Auditing Standards (GAAS), which include testing procedures and analytical procedures. The opinion states whether or not the Financial Statements are in accordance with GAAP. If there are no exceptions or other reporting issues with the financial statements, the auditor will issue a “clean” or “unqualified” opinion.

A review by an independent CPA is less comprehensive than an audit, and involves inquiry and analytical procedures. The report that the CPA issues provides limited assurance that the financial statements are properly stated. From the outside world, a reviewed financial statement is typically viewed as less reliable than financial statements that were subject to a complete audit.

In a compilation, the outside CPA firm has only prepared the financial statements using the financial information provided by the company. Little, if any, analytical procedures have been performed. From an outsider’s perspective, there is a lower level of reliance given to compiled financial statements.

Please refer to Attachment No. 5 for examples of a clean audit opinion, a review opinion, and a compilation letter.

F) Notes to the financial statements.

When a CPA issues a financial statement package with an opinion, the set of statements will include Notes to the Financial Statements. These Notes (often referred to as Footnotes) are included so that all relevant information related to the company’s financial position is adequately disclosed. Footnotes explain further details about, for instance, methodologies used for revenue recognition, related parties and transactions with these parties, assumptions or estimates used, material transactions, loan terms, subsequent events, and sometimes include supplemental detail schedules.

Please refer to Attachment No. 6 for sample Notes to the Financial Statements.
G) **CPA standards governing audits versus providing expert services**

As discussed above, a company’s financial statements can be issued together with an opinion from a CPA that he or she has audited the statements and found them to be in accordance with GAAP, and consistently applied. In performing the audit, a CPA must follow the American Institute of Certified Public Accountants’ (AICPA) Statements on Auditing Standards (SAS’s, or the Auditing Standards). Although there are several aspects to the SAS’s, one important element is that the CPA must be independent with respect to the company being audited. The concept of independence is thoroughly discussed within the Auditing Standards, and can be somewhat complicated. In essence, it calls for the CPA to be independent in fact and in appearance, and not to be in a position where he or she has any financial interest or management involvement in the company being audited.

CPA’s are often called upon to offer expert services, including testimony, for clients. As discussed in Section VII of this paper, the independent CPA auditing a Company is often not the professional selected to perform the expert services role for the client. This decision is typically not a matter of independence or lack thereof, but concerns itself more with the issue of discovery. For example, if the Company CPA is offered as an expert on a matter, it could lead to discovery of financial matters in the litigation beyond the scope of the particular dispute being litigated. To avoid that, another CPA is often selected to serve in the role of the expert in the litigation.

When a CPA performs expert services, these are considered Consulting Services under the AICPA rules (as opposed to services covered by the SAS’s). As such, the CPA follows a different set of rules/standards; namely, the Statement of Standards for Consulting Services (the Consulting Standards). The Consulting Standards have some similarities to the Auditing Standards, including the need to follow the AICPA Code of Professional Conduct. One difference, however, is that the CPA does not need to be “Independent,” as the AICPA defines that term. Instead, the practitioner
must maintain integrity and objectivity in the performing of his or her services. Objectivity requires the CPA to be impartial, intellectually honest, and free of conflicts of interest. From a practical standpoint, however, most lawyers would want to make sure that any CPA being selected as an expert in a litigation matter is also independent in the sense of not having any financial interest in the company and with respect to the outcome of the litigation. For example, if a CPA had an arrangement whereby he or she was paid a bonus if the client result was a success, opposing counsel could use that fact to suggest that the CPA’s testimony was not objective.

IV) **Key accounting reports and ledgers in the construction industry**

The financial statements discussed above can be considered the end-product of many inputs of more detailed reports and records. In this section, we will address key reports and inputs that are subsets of financial information, and which can be useful in obtaining more detailed information about a particular area. These include job-cost reports, labor-distribution reports, equipment-utilization and equipment-ownership records, and productivity records.

A) **Job-cost reports**

A job-cost system is necessary to track the cost and revenue of a specific project. With a robust job-cost system, items related to a particular project can be coded directly to an individual project, with further breakdown available by cost type, activity type, etc. Job-cost reports are very useful when determining and validating legitimate costs for a project. The information can be presented at a summary level, or at a detail level to see every transaction that has been charged to a project. In addition to tracking performance for internal reporting, a detailed job-cost report is beneficial and is often used to support costs associated with a claim, back-charges, or similar circumstances. The job-cost report also normally includes budgeted data, so that variances and overruns can be identified. This is extremely important since, under GAAP, if a company projects
that it is going to lose money on a project, that loss must be recognized when projected (as opposed to when it will occur in the future).

B) Labor-distribution reports

Labor-distribution reports provide a detail of how labor has been charged across projects. The reports can be presented by person or for a specific project, and are often used by outside parties to validate employees’ time spent on a project, and to ensure there are not more hours charged to projects than a standard work week.

C) Equipment-utilization reports and charge-out reports

Many construction companies (or their affiliates) own their own equipment such as forklifts, cranes, backhoes, trucks, etc. At the time of purchase, each piece of equipment is recorded on the Balance Sheet as an asset. Depreciation is the method of attributing the cost of an asset across its useful life. The asset’s book value is defined as the original purchase price less depreciation taken to date. Typically, detailed records such as purchase date, purchase price, serial number and the useful life for each asset are kept in a fixed-asset ledger. This information is then used to determine the amount of depreciation attributable to each asset in a given period.

As equipment is deployed on a project, its usage is often tracked to properly allocate the cost of its operation to the project. The method of allocation to a project can vary from company to company. The equipment may be associated with its operator and charged out according to the hours worked by the operator. Or it may be charged out as a flat daily or monthly rate. Reports are usually generated to track the productivity and usage of the equipment fleet in relation to the actual annual costs. If it is under-utilized, the additional cost is typically captured in cost of sales on the Income Statement. Conversely, if it is over-utilized, it is typically a reduction to the cost of sales on the Income Statement.
D) Labor-productivity records

Projects have budgets for estimated labor required to perform tasks. Labor productivity records are necessary to determine how much labor and material have been expended compared to the budget. A robust time tracking system is helpful to determine the productivity for a given task or area. The productivity is closely monitored so that adjustments to crews and/or performance can be made quickly to ensure the project remains on schedule and within budget. This information is often used in claim situations for inefficiency claims, where measured-mile information is extracted to demonstrate that the company was able to perform at a certain level absent impacts and delays caused by others.

V) Revenue recognition and related issues

Revenue recognition in the construction industry is unique from other industries since most contracts are of a long-term nature and may span over several accounting periods. The majority of the industry uses the method of revenue recognition known as Percentage of Completion.

Under this approach, revenue is recognized based on the percentage of the contract that is complete on a cost basis. The percent complete is calculated using the following formula: Total actual cost incurred/total cost forecasted. For example, if the project has expended 40% of the estimated cost, then 40% of the revenue and 40% of the gross profit will have been recognized over the life of the project. Billings to the owner have no impact on the amount of revenue recognized when using the percentage of completion method.

Revenue should be calculated on a per project basis. To properly calculate revenue, it is important to have a system that can capture estimates and costs by individual projects. Typically, projects are shown on a Work-in-Progress Schedule (WIP).

Please refer to Attachment No. 7 for an example WIP schedule.
If a project is expected to be in a loss position, accounting rules require the entire loss to be taken at once. Therefore, the percent complete as of the balance-sheet date does not apply to the gross profit in this situation. Revenue is still calculated on a percent complete basis, but no gross profit will be recognized going forward as long as the project remains as an estimated loss.

VI) **Home-office overhead (G&A) issues**

As mentioned in Section II above, home-office general and administrative expenses (G&A costs) often become problem areas between parties involved with a construction project. This is primarily because the issue of G&A costs ties into many other areas, such as mark-up provisions in the contract; duplication of cost areas; contract provisions precluding certain types of costs; costs considered unallocable; and credits for G&A costs already recovered when presenting delay-cost submissions or claims. Professionals working in the construction industry are often faced with questions relating to this subject, the answers to which are important to advising clients as to positions to take in a particular matter. Many of these issues deal with supporting accounting and financial reports and information. The following is a listing of some of these questions, along with a discussion of each question/issue and our comments/answers to each.

**A) What are home-office general & administrative (G&A) costs, and how are they typically allocated and recovered on a construction project?**

As outlined in Section II, G&A costs are the costs of managing the business as a whole. They are not viewed as relating to a specific project, but are incurred for the benefit of all projects. As such, they are typically allocated on a percentage basis by a contractor in a bid, and they are often combined with the profit percentage being bid, as part of what is referred to as the margin percentage.
B) Are G&A rates generally consistent for construction companies and how does size impact the rates?

The short answer to this question is no – especially for smaller companies. It is important to review the components of what a company is calling their G&A costs (sometimes called Administrative Costs on its financial statements). For example, some companies might include the depreciation on all of its direct construction equipment, so if separate cost submissions or claims are being put forth for equipment using equipment manual (or internal) rates, those costs would normally be excluded from the rate calculation. Similarly, some companies might have its general superintendents in the G&A cost pool, as well as interest costs or other unique, one-time issues (a large bad debt write-off), so comparability is not always possible. For the very large companies, the G&A rates do tend to drive much lower because of the volume (e.g., below 5%), but even that can become complicated if separate divisional rates are used (e.g., special rates for international or government work, etc.).

C) How does one assure that there are not some costs being charged directly (and claimed) that are also in the home-office-overhead rate?

As mentioned above, it is important to look at the components of the rate. As with the bad debt example above, some of the costs in the pool may not be “allocable” to the contract at issue since they relate entirely to a problem on another contract. Similar examples exist with equipment charge rates, superintendent costs, IT charges, safety, etc.

D) What is the difference between markup rate (on direct extra work costs, etc.) and daily rates for delay (e.g., Eichleay formula), and are both permissible?

In Section II, we referenced the mark-up rate approach used by companies when bidding a project. Similarly, many contracts have rates for G&A costs and/or margin incorporated into the contract and stipulated for use on extra work or changes. In those situations, the calculation of a company’s actual G&A rate from its financial statements becomes irrelevant. For delay situations,
companies often develop daily rates based on allocating its G&A costs to the project and then dividing that amount by the number of days of the project. That daily rate is then applied to the extended project days that are the responsibility of others. In those situations, it is important not to duplicate claims based on mark-up and daily rate approaches, so adjustments are normally appropriate. In some federal-government contracts, the government agency requires that only one method be used (i.e., mark-up or daily rate) for any G&A cost claims (as well as for field office overhead claims). Contractors should be aware of these situations when preparing change orders and claims under federal contracts.

E) Are construction companies and engineering/construction management firms comparable in terms of how they develop home office G&A rates?

G&A rates for engineering or construction management firms (E/CM) are very different than those for general contractors (GC). For E/CM firms, their rates are primarily derived as a percentage of the professional salaries of the individuals assigned to the contract. As such, the base (salaries) for an E/CM firm is much lower than that for a GC (i.e., total cost of all construction operations). A GC will typically have a much lower rate since the denominator in the rate calculation includes all costs of performing its operations, including the subcontract costs being managed.

F) What elements of a G&A rate are critical when looking at how to allocate such costs?

As mentioned above, issues like equipment, general superintendents, and bad debts are often problematic. Not all of these costs are truly “allocable.” In addition, as with all reimbursement questions on a project, the contract terms often dictate what can, and cannot, be part of a direct charge for a project. For example, if there is a stipulated rate in the contract for G&A or margin, the contract provision often dictates what is included in the rate, making those cost categories non-reimbursable directly or as part of any rate claim.
VII) Other financial-accounting-related issues

In addition to the G&A rate issues discussed in the previous section of this paper, the treatment of other cost elements results in issues in many cases. The following is a discussion of some of these cost areas, together with some specific questions relating to financial and accounting sources for each.

A) Equipment-related questions

1) Where are a company’s equipment-related costs recorded on its financial statements?

As mentioned in Section II above, smaller companies often include the depreciation as part of G&A. In larger companies, the costs are properly treated as part of direct job costs, either in total, or as part of an internal charge-out system where costs are assigned to projects at predetermined rates, with year-end adjustments to “true-up” the allocations.

2) How do you calculate actual costs for a company’s owned construction equipment?

The calculation of actual costs for construction equipment is a fairly complicated subject. Many companies set up divisions or related corporations to own the equipment and then “charge-out” at rates intended to capture the depreciation (cost recovery over time), insurance, property taxes, major maintenance, and other equipment ownership related costs. The operating costs, such as gas, oil, minor repair and maintenance, etc. are typically charged to the project directly for the usage of the equipment on the job, but these can also be captured and allocated/assigned from a home office division or separate corporation and included in the “charge-out” rates.

3) How do I know if a construction company has a captive related-party company that owns its construction equipment and bills it at pre-established rates?

This information would be disclosed in the footnotes to the financial statements, as are any transactions with related parties. This is required under GAAP.
4) What if a company cannot readily calculate its actual equipment costs, and defaults to rate manuals (e.g., Blue Book, US Army COE, etc.) in its cost submissions?

This happens often – especially with respect to smaller companies. Care must be taken in those situations that other cost submissions or claims (e.g., daily field overhead rates, G&A rates, etc.) do not also include the costs of owned equipment as discussed above. The key point here, as with many other cost areas, is to determine what the contract says. Often, the contract will call for a specific rate manual or approach for equipment (e.g., 80% of the Blue Book ownership portion of the rate, etc.), and care must be taken to make sure that the proper manual and edition are being used.

B) Insurance-related costs

1) Is it permissible for a company to include insurance costs in its labor burden rates and also as “adders” to the contract?

The recovery of insurance costs is dependent on the type of insurance costs at issue. Worker’s compensation and unemployment insurance policies are normally recovered in the payroll burden rate applied to labor. Sometimes, a contractor will also include other insurance policies (e.g., general liability, umbrella policies, etc.) in the labor-burden rate, but these are more commonly found as an add to the total-cost amount being presented since the premiums for liability are normally based on total volume and not necessarily on labor. The key is to make sure that they are not duplicated by being included both ways.

2) How does a company calculate its insurance costs if it is self-insured, and where do they show up in its financial statements?

Self-insurance costs can be very complicated to calculate and monitor. In basic terms, a company makes a self-insurance charge under an actuary approach annually for the type of insurance to which it relates. Under federal contracts, there is a Cost-Accounting Standard (CAS 416) that outlines how this is treated. From a non-actuary/accountant perspective, the key is to
review the notes to the financial statements if insurance becomes an issue and determine the basis and amounts of the self-insurance charges. Given the complexity of calculating costs for self-insurances, contracting parties typically try and liquidate these rates in the contract or in agreements shortly after signing the contract.

C) Other financial-statement issues

1) Given the knowledge that a contractor’s independent CPA firm auditor has of the company, does it make sense to use him or her as an expert witness for purposes of efficiency?

Although, at first blush, it appears to be efficient to use a company’s independent CPA as an expert witness in a lawsuit, most lawyers would normally advise against it for one simple reason --- the company’s CPA may, in fact, know more about the accounting and costs of a company than the lawyer/company would want disclosed in the particular litigation. For instance, the CPA might be aware of key ownership-compensation levels, past tax issues, and other financial and tax matters that could potentially become discoverable if the CPA is put forward as the expert and subject to deposition examination and trial cross examination. For this reason, lawyers typically look for someone not affiliated with the financial reporting of the company at issue.

2) Is it possible to determine from a company’s financial statements how much they are estimating that is recoverable on a claim? If so, where would that be found in the statements?

The short answer here is no. The financial statements or the notes to the statements normally do not, on their face, permit determination of the estimated recoverable amount of the claim. GAAP provides guidance to an independent CPA on determination of whether or not cost overruns/claims can be booked for financial reporting purposes. The CPA would normally then conclude that any reserves or allowances have been adequately considered in determining the amount of revenue that has been booked and recorded in the current year’s financial statements.
VIII) Conclusion

As discussed throughout this paper, the financial and accounting records of a company contain a significant amount of information that can be important for construction attorneys and other professionals to understand. A basic awareness of the basic accounting, finance and reporting aspects of a construction company can assist a practitioner at various stages of the construction project cycle – from contract formation/drafting through the litigation process. Hopefully, the foregoing provides a basic framework for such awareness.