Review Your Accounting System

What to Expect in Government Construction Contracting

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Today’s Areas of Focus

- Internal corporate accounting system
- Overview of some clauses unique to Federal contracts
- Issues to consider as you prepare Federal contract bids
- Joint ventures
Contractor Goals

• Get work
• Make a profit
• Get paid
Where’s the Money?

In recent years, the largest money amounts of Federal contracts have gone to companies in:

- California
- Virginia
- Texas
- Maryland
Business Challenges of Gov’t Contracts

• Competition is fierce
• Profitability is low – very dependent on accurate bidding and operational efficiency
• Penalties for failing to comply with the large number of government regulations can be severe
Types of Construction Contracts

Typically, federal construction contracts are going to be either

- Fixed-price
- Unit-price basis
- Or, a combination of the two

At times, cost-plus contracts may also be awarded
Internal Accounting System

Why Is It Important?
Internal Accounting System

Good Accounting Records Can Protect You!
Contract Costs

May be audited to ensure
• Contract procedures are followed
• Accounting rules are followed
  – Many businesses struggle with the concept of generally accepted accounting principles (GAAP)
Businesses Often…

Prepare line-item bid estimates

But fail to:

• Use actual overhead rates
• Enter cost budgets into the accounting system
• Match actual costs with the bid estimate line items
Businesses often fail to...

- Provide management with cost variance reports
- Have a formal system in place to allocate labor burden to jobs
- Have a formal system in place to allocate an indirect overhead burden to jobs
- Record costs by bid line items
Estimating department and accounting department often work independently of each other

- **Estimating department**
  - Generates detailed cost estimates using specific cost codes or phases of a project
  - Applies overhead burden
  - Adds desired profit margin
  - Does not provide accounting with a copy of the contract nor the bid estimate
Accounting and Estimating Departments

- Accounting department
  - Not aware of contract terms and conditions
  - Does not track costs appropriately
  - May not be in compliance with all reporting requirements

- Failure to comply with Federal contract reporting requirements can delay payments
Federal Acquisition Regulations (FAR)

- Contains policies and procedures for all acquisitions
- Created to bring uniformity and structure to Federal contracting
- Dictates the way in which a contractor must maintain its accounting system
- Instructs contractors how to account for certain types of costs
- Bible of Federal government contracting
Government Contracts

- Frequent change orders
- Require contractors to provide detailed cost breakdowns for changes
- Contractor is expected to have available accurate records of costs and labor to date
Cost Records

- May be manual
- May be sophisticated, computer-based systems
- Should be
  - Accurate
  - Consistent
  - Verifiable
Subcontractors

- Generally subject to the same terms and conditions that apply to the prime contractor
- Prime contractor is contractually liable for its subcontractors’ compliance with various contract rules and regulations
  - Government can reduce payments to the prime contractor for subcontractor violations
Clauses Unique to Gov’t Contracts

- Government has the right to unilaterally change contract
- Contractor has right of equitable adjustment
Formal Change Orders

- Entitlement acknowledged by government
- Negotiated in advance
- Negotiation often line by line
Constructive Changes

- Caused by informal action, failure to act or omission by government
- Must determine entitlement
- Difficult to identify, document and quantify
- Costs may be difficult to prove
Termination for Convenience

• Government has right to change the scope of contract by terminating all or a portion of remaining work

• Contractor entitled to recover costs plus profit and settlement costs
Termination for Default

• Caused when contractor defaults on a term, condition, or requirement of contract, e.g.
  – Delivery schedule
  – Failure to make adequate progress on work
  – Failure to comply with a material requirement

• Contractor may be liable for government’s increased costs
Claims

• Arise from disputes over change orders or constructive change orders
• Burden of proof may be on contractor
Challenging Areas for Businesses

• Labor burden
• Internal equipment burden
• Indirect overhead burden
Labor Burden Cost Pool

- FICA, FUTA, SUTA
- Workers’ compensation
- Health, life, disability insurance
- Retirement plan contributions
- Bonuses
- Leave, training, downtime
Owned Equipment Cost Pool

- Depreciation
- Insurance
- Property taxes
- Licenses
- Repairs and maintenance
- Fuel, oil, supplies
- Interest on equipment loans
- Shop facilities, etc.
Indirect Overhead Cost Pool

- Costs related to support of field construction activities
- Project management
- Superintendents
- Superintendents’ trucks
- Security at job site
- Project engineers
- On-site clerical, safety, cleanup
- Temporary facilities and roads
- Utilities
- Travel
- Data processing incurred in connection with contract functions
Methods of Allocation

Allocation method of these various cost pools may be computed

• As a flat rate per labor hour
• As a % of total labor costs
• Owned equipment – allocation % may be based on hours of usage
• Combination of labor and materials
• % of total direct costs
Socio-Economic Obligations

- Equal opportunity and Affirmative Action Plan (AAP)
- Subcontracting plan ($1 million for construction jobs)
- Labor standards (i.e. minimum employee wages)
- Drug-free workplace requirements
Recovery Act Funds – Quarterly Required Reporting

a) The dollar amount of contractor invoices;
b) The supplies delivered and services performed;
c) An assessment of the completion status of the work;
d) An estimate of the number of jobs created and the number of jobs retained as a result of the Recovery Act funds;
e) Names and total compensation of each of the five most highly compensated officers for the calendar year in which the contract is awarded; and
f) Specific information of first-tier subcontractors
Compensation Reporting Required If

- Preceding year – 80% or more of annual income was from Federal contracts; and
- $25 million or more in annual gross revenues from Federal contracts; and
- Public does not have access to officers’ compensation
Due Date of Reports

- Reports must be submitted no later than the 10th day after the end of each calendar quarter
- Reports must be submitted online at www.FederalReporting.gov
Joint Ventures
Hoover Dam

- Great example of a successful joint venture
- Largest Federal project of its era
- Consortium of 6 companies
- Project completed 2 years ahead of schedule
Advantages of Joint Ventures

- Members share risks and rewards
- Combine financial and other resources
- Obtain financing
- Bonding
Joint Venture Agreement

• Dictates the responsibilities of each member
• Dictates ownership percentages
• Directs the accounting for the joint venture
• Should be carefully and rigidly structured by an experienced contracting attorney
Joint Venture Agreement

- Common issues that should be addressed in the agreement
  - Billings and collections
  - Revenue allocations
  - Expense sharing
  - Cash distributions
  - Administrative issues and accounting procedures
Forms of Ownership

Ownership of the joint venture can take many forms

- Partnerships (most common form)
- Limited liability companies
- Corporations
Method of Accounting

- **Cost method**
  - Most appropriate when the member’s ownership is less than 20%

- **Equity Method**
  - Most commonly used method
  - Generally used when member’s ownership is between 20% and 50%
  - “One-line” method
    - investment in joint venture is shown as a separate line item on the members’ balance sheet
    - earnings and losses are shown as a single net amount on the income statement
Consolidation Method

- Used when *more* than 50% of the joint venture is owned by the consolidating member
- Minority interests are disclosed on the balance sheet and income statement
- Most commonly used when minority contractors team up with larger contractors or partnering programs or Section 8a contracts
Advantages of a Joint Venture

- Allowing contractors to raise additional capital
  - Member does not have to be a contractor
  - Member may be a developer
  - Member may be a private equity investor looking for a high return on the investment
Advantages of a Joint Venture

• Management flexibility
  – By forming a separate entity, a large member may have more flexibility
  – Less “corporate guidelines” to meet
  – Decisions can be made more quickly
Advantages of a Joint Venture

• Ability to grow and diversify
  – Contractor may be able to stretch the boundaries it may have had as a stand-alone entity
  – Availability of resources
Disadvantages of a Joint Venture

- Loss of control
  - Biggest deterrent of a joint venture
  - Each party works independently
Disadvantages of a Joint Venture

• Lack of compatibility with other members
  – Different management styles
  – Different corporate cultures
  – How do you collaborate without stepping on each other’s toes?
Disadvantages of a Joint Venture

- Could result in a loss of business reputation
- Could diminish credit standing
Recommendations

• Look for companies with
  – Good reputation
  – Perform quality work
  – Integrity
  – Similar corporate cultures
Recommendations

• Potential partner(s)
  – Honest interest in joint venture
  – Commitment to the operation
Recommendations

• Structure the joint venture to
  – Capitalize on each other’s strengths
  – Hire an attorney to carefully and rigidly structure your joint venture
Recommendations

- Joint venture agreement should address questions such as:
  - How will the joint venture be financed?
  - Who will manage the job and make decisions?
  - Are you willing to accept the risk of failure because of incompatibility?
  - What and how will each party contribute to the project?
  - How will the smaller contractor’s interest be protected?
  - How and when will profits be distributed?
  - How and when will losses be paid for?
Recommendations

- Open and honest communication
- Anticipate areas of conflict
- Build procedures into the agreement to avoid an impasse
Recommendations

• Develop an exit strategy at completion
Questions

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THANK YOU.