

CEN 421 Week 1 Lecture S20

These lecture notes are meant to be a complement to the textbook. It is essential that the student reads and understands the material in the textbook.

Financial Management

Financial management is critical to the success of a construction project and to the construction company. After all, we are in business to make money, so it is essential that we understand finances and financial management. Major decisions such as which jobs to bid on; using subcontractors or doing the work in house; or purchasing or leasing equipment will be determined by financial analysis.

Project Controls

Construction is different from most other business because it is project oriented. Therefore, it is essential that the project manager as well as the company executives understand construction accounting and financial management.

Cost control will ultimately determine if the construction company makes a profit or it fails. Cost control starts with a good budget and cost reporting. Since construction companies are project oriented, cost reporting must be by project. Project managers as well as the general manager are very busy people. Therefore, a timely exceptions report will allow management to spot problems early and take corrective action.

Accounting Ledgers

The three ledgers normally used by construction companies are: the general ledger, the job cost ledger, and the equipment ledger. These ledgers must be integrated in order to control costs and have the information available to prepare tax returns.

A chart of accounts lists all of the accounts in the ledgers. These accounts are used both in preparing the estimates and in cost control. Comparing the actual costs with the estimate or budget will show management where they are on track and where they need to take action.

Retention

Most construction contracts have a retention clause. Typically, the owner will retain 10% of the contract amount until the final inspection is completed. The accounting should indicate the amount completed, the amount billed, the amount paid, and the amount retained.

Financial Statements

Students should be familiar with accounting statements. These statements include a balance sheet, an income statement, and a statement of cash flows. In addition to these, construction companies will also have a job cost ledger and often an equipment ledger. Since construction is a project-oriented business, the job cost ledger is critical project and corporate management. Most construction companies use expensive pieces of equipment; therefore, it is very useful to have an equipment ledger that will track the cost of each piece of equipment on each job. This will allow management to determine if it is better to own or lease the equipment.

Labor Costs

Labor is a large part of every contract. In addition to the direct labor cost, all of the employee's fringe benefits and his portion of the Social Security, Medicare, and income tax must be withheld.

Equipment Costs

Equipment is depreciated for tax purposes. Since the equipment will last for several years, the IRS will not allow you to expense it in one year, rather it must be written off over the life of the equipment. As the equipment is being depreciated, the book value each year is the original cost less the accumulated depreciation. When equipment is sold, a tax must be paid if the sales price is greater than the book value. If the sales price is less than the book value, a tax refund is due.

Internal Controls

It is very important that controls be established to prevent fraud and employee theft. As a side note, let me tell you about Barings Bank and the need for internal controls. Barings was one the oldest British merchant banks. In fact, Thomas Jefferson borrowed the money from Barings to buy the Louisiana Purchase from Napoleon. This old very famous bank was bankrupted by a 28-year-old trader in their Singapore office due to a lack of internal controls. Internal controls should include two signatures for checks, a second person authorizing large expenditures and a paper trail for everything.