

RAISING THE FINANCIAL REPORTING QUALITY OF CONSTRUCTION COMPANIES

A HOLISTIC APPROACH

In our previous instalment, “Meeting the Grade: Why Audit Opinions Matter to Construction Companies” in *CPA Singapore* (Nov 2012) issue, we had shown how a modification to the auditor’s opinion may result in a potential downgrade of the Building and Construction Authority (BCA) Contractors Registration System (CRS)¹ and further discussed some challenges faced by both preparers and auditors of financial statements of construction companies. We shall proceed, in this instalment, to discuss how these challenges may be overcome through a holistic approach adopted by the construction companies.

When properly prepared, financial statements provide useful information which enables companies to monitor their financial health and evaluate their financial performances over a period of time. Useful business analytical ratios and projections can also be churned out using this financial information. Additionally, management can use such outputs as a basis to chart appropriate strategies and business plans, thereby helping to maximise returns to shareholders.

This is even more so for construction companies whereby, owing to the nature of construction contracts, the initiation and completion dates of construction contracts usually straddle across different accounting periods. Further, management judgement is required to estimate the amount of variation order to be recognised as revenue in the event that such variation orders have not been approved. By properly accounting for the construction contracts undertaken, and properly allocating contract revenue and contract costs to the accounting periods in which the construction works are performed, management

would be able to gain a clearer insight and be able to track the progress of projects, determine projects which are profitable and whether there are any foreseeable losses.

That said, construction companies have faced a number of challenges¹ which could have negatively affected financial reporting, which in turn led to lower quality financial information being produced for decision-making purposes.

Yet, resolution is often easier said than done.

In the following case study, we identify potential bottlenecks that prevent satisfactory resolution and explore how we can resolve these issues through a holistic approach. The holistic approach is termed “ACE”, short for **A**ttitude, **C**ommunication and **E**ducation.

CASE STUDY: BO-CHAP CONSTRUCTION PTE LTD (BO-CHAP)

As part its new business strategy, Bo-Chap is planning to bid for more public sector projects. However, it has a problem. During the previous audit, the auditor had modified the auditor’s opinion and had also highlighted the following challenges faced in ensuring that Bo-Chap

WHEN PROPERLY PREPARED, FINANCIAL STATEMENTS PROVIDE USEFUL INFORMATION WHICH ENABLES COMPANIES TO MONITOR THEIR FINANCIAL HEALTH AND EVALUATE THEIR FINANCIAL PERFORMANCES OVER A PERIOD OF TIME.

¹ Please refer to “Meeting the Grade: How Auditor’s Opinions Matter to Construction Companies, *CPA Singapore* (Nov 2012) issue for the first instalment of the article.

had complied with the requirements of Financial Reporting Standard 11 (FRS 11) *Construction Contracts*:

- a Inability to obtain sufficient appropriate audit evidence on whether the revenue is recognised by reference to the stage of completion of contract activity;
- b Inability to obtain sufficient appropriate audit evidence on the validity, completeness and accuracy of the total contract sum due to the lack of proper documentation on customer approval for variation orders received;

- c Inability to obtain sufficient audit evidence to corroborate management's assessment of the total estimated contract costs to complete as the basis for total estimated costs were often not substantiated with the appropriate supporting documents from the operational staff and project managers; and
- d Difficulty in assessing provisions made for foreseeable losses as losses such as delays, cost overruns and liquidated damages were either not provided for by management, or management's assessment of such losses were not properly substantiated

The auditor had indicated that similar to the previous financial year, the auditor's opinion will be modified if the impacts of the limitations of scope in (a) to (d) above are material to the financial statements for the current financial year.

Similar to the previous financial year, the modified auditor's opinion could lead to a downgrade in

Bo-Chap's BCA grading under the Construction Workhead (CW)¹ registration category and possibly lower Bo-Chap's tendering limit for public sector projects. Concerned with the possible downgrade now that Bo-Chap is planning to bid for more and larger public projects, management of Bo-Chap had undertaken to resolve the issues before the next audit. The Finance Director (and his team) was tasked to take charge of the project.

The Finance Director had compiled his team's findings and had identified three areas which could potentially impede progress.

Having discussed them at length with a consultant, the findings and recommendations are presented as follows:

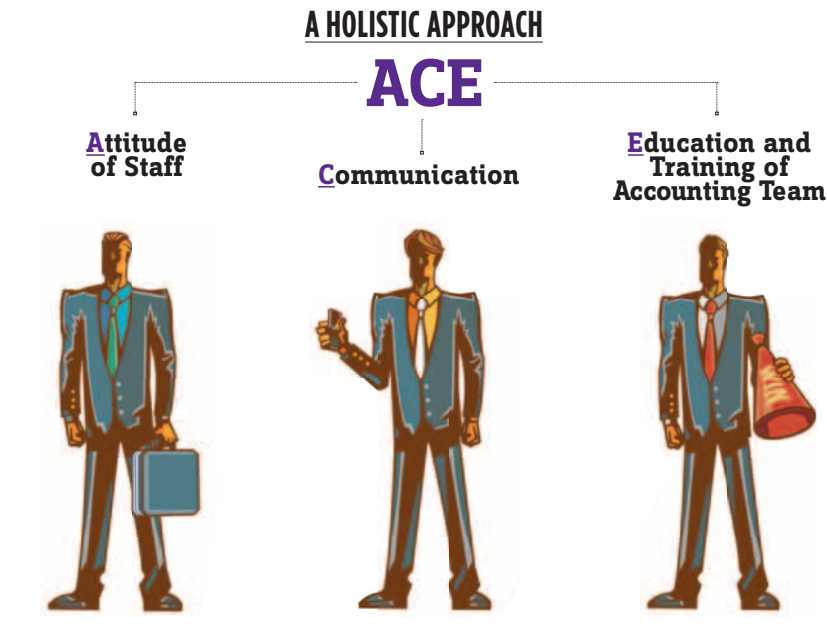
AREA 1: "A" FOR ATTITUDE OF STAFF

For most staff (and management) in Bo-Chap, the financial reporting process serves only to increase the



FIGURE 1

Raising the Financial Reporting Quality of Construction Companies



costs incurred by their businesses and exists for the sole purpose of regulatory compliance. The other staff usually did not regard proper record-keeping and documentation as part of their scope of work and also felt that it was the duty of the accounting team to piece together whatever was provided to them into proper records and documents.

This negative attitude was particularly prevalent among the operational staff and project managers, who “never had time” to properly maintain documentation on customer approval of variation orders or retain documentation which will support the variation orders, despite repeated reminders by their accounting colleagues.

Recommendations

- 1 As a start, the Finance Director could steer the management team in the right direction by showing them how financial information (and business analytics ratios) could be used as a tool in strategic decision-making.
- 2 He could further stress to them that a lack of proper records underscored a possible lack of accountability among the operational staff and

FOR FINANCIAL INFORMATION TO BE USEFUL, IT WOULD FIRST NEED TO BE ACCURATE AND REPRESENTATIVE OF THE TRANSACTIONS UNDERTAKEN.

project managers, since staff who do not track their projects would not have ready evidence of the status and possibly the profitability of their projects. Besides, poor record-keeping practices would also increase the likelihood of disputes on variation orders with customers.

- 3 Once management’s mindset has been changed, the Finance Director and his team would have an easier time in cascading the proper record-keeping and documentation practices down the operations of other departments.

AREA 2: “C” FOR COMMUNICATION

The importance of communication as a tool for transformation can never be over-emphasised. Yes, communication is important, because it enables the accounting team to have a better idea of the status of the construction projects and obtain from operational staff the most updated estimated cost to complete to

determine profitability. Good communication between the operational staff and the accounting team would also enable the operational staff to be aware of what are the necessary supporting documents to maintain to support their accounting colleagues’ efforts in ensuring compliance with the requirements of the accounting standards.

Yet, was communication properly done?

Judging from complaints by the staff in other departments, the answer was no. Instructions provided were either not detailed enough, or contained too many accounting jargons for the operational staff to understand, much less to incorporate into their daily routines. Also, since communication was only made to them near the end of the last financial year, many transactions were already completed (and unrecorded) before communication was made. Worse, the accounting team appeared to be unsure of what the auditor was looking for with regard to the basis for management’s assessment of the total estimated contract costs of construction projects and often had to seek clarifications on the same

contracts from the operational personnel repeatedly. This made it a frustrating experience for the operational staff.

Recommendations

- 1 To facilitate proper communication, the accounting team should consider using simple English (instead of accounting jargons) to communicate with the operational staff when they let them know what “proper records and documentation” they need to maintain.
- 2 To provide more clarity and timely communication on the maintenance of proper records and documentation, the accounting team could suggest that the standard operating procedures (SOPs) be amended early in the financial year to incorporate the maintenance of proper records and documentation for each project.
- 3 To help the accounting team better understand the progress of each project, including the basis of variation orders, monthly meetings should be held between the project managers and accounting team.
- 4 The accounting team should also communicate with the auditors early in the financial year to get a better understanding of the requirements of the accounting standards, so that they may in turn communicate these requirements to their colleagues in advance.

AREA 3: “E” FOR EDUCATION AND TRAINING OF ACCOUNTING TEAM

Owing to their busy schedules, the Finance Director and his team seldom attended external training courses on the requirements of FRSs. Instead, the auditor was their primary source of information in ensuring that their financial statements were compliant with the FRSs.

² Please refer to www.icpaspe.org.sg for details of some training courses on Financial Reporting provided by ICPAS.

GOOD COMMUNICATION BETWEEN THE OPERATIONAL STAFF AND THE ACCOUNTING TEAM WOULD ALSO ENABLE THE OPERATIONAL STAFF TO BE AWARE OF WHAT ARE THE NECESSARY SUPPORTING DOCUMENTS TO MAINTAIN TO SUPPORT THEIR ACCOUNTING COLLEAGUES’ EFFORTS IN ENSURING COMPLIANCE WITH THE REQUIREMENTS OF THE ACCOUNTING STANDARDS.

Also, apart from the Finance Director, the others in the accounting team could only perform bookkeeping functions, such as posting of accounting entries, and could not review the accuracy of the inputs because there were no cut-off procedures and analytical review performed. The financial reporting close process was thus incomplete.

Recommendations

- 1 The Finance Director should ensure that he and his team receive the necessary training² so that they would not only be more proficient with the requirements of the accounting standards, they would also be better equipped to perform a more robust financial reporting close process.
- 2 As the accounting team becomes more proficient in accounting standards, they would be able to better communicate these requirements to their colleagues in other departments without relying on the auditors.
- 3 The accounting team would also be better equipped to review the financial inputs for accuracy. This in turn enhances the accuracy of financial information, making it a reliable tool in the strategic decision-making process of management.

CONCLUSION

For financial information to be useful, it would first need to be accurate and representative of the transactions undertaken. Better yet, it should be properly maintained on a timely basis so that management can have the most up-to-date information for their decision-making process.

Nonetheless, a number of challenges has been faced by construction companies in providing such information for their management’s use.

While these challenges appear to be accounting-related in nature, they can actually be symptoms of more deep-rooted and prevalent issues across the company. Therefore, a holistic approach (of which Bo-Chap has been used as an example) needs to be adopted to address these challenges. CPA

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