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How builders buckle under the weight of work in progress

BUSINESS

Proper accounting procedures can help measure the true cost of completing a job.

By Eddie Senatore•17 March 2023•7 minute read

Builders play in one of the most volatile industry sectors in the country. The league table for business failure places builders in the top three. Always. Often they take number one position. This has been the case for the 30-plus years that I have been tracking business failure statistics. But why are builders perennial contenders for the title of businesses that fail the most?

The answer is that there are many factors. One of these is the management of work in progress, projects under construction. When I work with builders, I often see the analysis or interrogation of work in progress being left for formal reporting processes, often performed annually and, in my experience, a best guess between builder and accountant.

For residential builders there is added pressure with this annual assessment as work in progress, together with the resulting gross profit margins, influence insurers that provide home warranty insurance (HOW).

HOW covers building work which is incomplete or defective and the builder has either disappeared, become insolvent during construction, or has failed to respond to a rectification order. Without HOW a residential builder cannot operate.

Importantly, HOW limits the number of homes a residential builder can construct in any given year. The more robust a builder's financial position the better the chances a builder will be granted the scope to build more homes annually.

Therein lies the pressure. I have seen some horrendous accounting around this. On one occasion I saw a set of accounts indicating a company had issued share capital of $100,000 represented as ‘cash on hand’. Not in the bank, but available, on hand. HOW was granted. There was no cash on hand. The builder had no cash. This seriously compromised the builder’s personal liability when he was called on the explain the whereabouts of the cash when the company was placed into liquidation, not to mention the risk of a report to ASIC for breach of director’s duties.

There is a constant theme emerging from my reading of the various liquidators and administrators’ reports on insolvent builders. That theme is around the management of work in progress. Often cited is the need for home builders to sign up new projects. One practical implication for signing up a new contract is accessing cash from the initial progress claims paid by home owners. Commonly these initial invoices are front loaded, due to a large percentage of the contract value being billed at the beginning of a project. This is a sensible approach, using owners’ money to fund construction.

However, builders need to be vigilant at the back of the project where there is little margin left in the closing invoices. The current volatility and surge in costs of materials alone is enough to throw the industry into crisis. We are now seeing this play out every day.

A secondary issue is the portfolio approach taken to the management of projects by builders. In this situation builders manage loss-making projects by absorbing the deficiency they generate with the cash available from performing projects. The more projects you take on, particularly in the case of front loading, the better the cash flow to help manage the portfolio of work.

In the current climate where cash is tight, there is added pressure to win more work. Winning work comes at a price. In competitive times builders price keenly. This means builders compromise their margins to win work to enable access to the cash from front-loaded progress claims on new projects. This cycle continues. Increased costs in materials and labour shortages makes this a tough cycle for builders to manage.

For such a critical element of a builder’s business, work in progress cannot afford to be an annual activity between accountant and builder, and HOW. The accounting for work in progress is governed by AASB 15 and tax rulings. This makes work in progress a compliance activity. It also assesses work in progress on an artificial, generally accepted accounting 12-month, 30 June end period cycle. Builders, on the other hand, work and think on a project basis.

For management purposes builders should be assessing work on progress on a monthly, and – given the volatile nature of the industry – weekly basis. The frequency and magnitude of the changes in material and labour costs needs this level of scrutiny. Builders will better understand the resources available to them by assessing work in progress for management purposes on a cost-to-complete methodology basis. When this assessment is undertaken correctly it will present work in progress on an over or under-billed basis.

For example, a builder has signed a client to build a home with a contract value of $1 million. The builder issues a progress claim for $500,000. Assuming 25 per cent of the work has been completed, based on a cost-to-complete method then $375,000 represents the overbilling portion of the progress claim. Essentially this represents other people's money or unearned revenue. This has a totally different balance sheet implication. Available liquidity can then be better understood.

It's sensible to be ahead of the game in this way so long as the funds are properly reported and managed. However, you can now sense the temptation builders face when they have loss-making projects, particularly under the portfolio approach to managing projects. It all simply blends into one number: cash at bank.

The benefit of the under and over-billed approach to management of work in progress is that it indicates to a builder how much of the cash sitting in their bank account represents other people's money and as a consequence what is free cash. In addition, and importantly, it requires the builder to continually assess the cost-to-complete on projects. It also provides for a quick assessment as to the status of a builder's margin, testing whether the builder has applied the appropriate mark up.

It will also enable a builder to look into the immediate future to predict liquidity needs knowing they hold some cash as unearned revenue. I'm not talking about a six or 12-month projection here – I'm talking shorter, much shorter, monthly to quarterly. It may well be that a builder is comfortable in sacrificing the margin on one project to cover the costs or losses on another, but this can only be achieved and managed effectively with timely and accurate financial information and an understanding of what cash at bank represents.

Accountants have the ability help builder clients through this. It doesn't take a lot of effort. The assessment can be undertaken with the use of a simple excel spreadsheet, calculating the under and over-billed portions. It will require the builder to have a handle on costs-to-complete and any variations to the contract value. The builder's internal management information system should produce this data. If it doesn't, then that is a problem too, and this presents accountants with a further opportunity go deep into a client's business. This pushes accountants into the advisory space.

Reducing business failure statistics for the building industry requires more than dealing with compliance of accounting standards and tax rulings. Improvement in regulations will do little. It requires active engagement by an accountant or adviser to walk in the shoes of your builder client to understand the flow of projects, the costs and whether projects are under or over-billed. Then how to manage this for the benefit of your builder clients and the customers your builder serves.

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