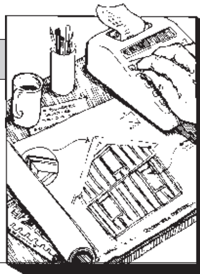
IN BUSINESS

Keeping Accounting Records

by Irv Chasen



Accounting and CPA firms generally provide their clients with a packet of standard information when they submit the completed financial statement. This standard packet includes the following documents:

- Letter of transmittal
- Balance sheet listing the client's assets and liabilities
- Statement of income and retained earnings—this is commonly known as a Profit and Loss or P and L Statement
- Statement of change in financial position (distribution of capital)
- Notes on the financial statements

When receiving these documents, the contractor's first question is usually, "Am I making any money?" Most turn immediately to the P and L Statement, assuming that it provides all the information they need to know about the financial position of their business.

Logically, the P and L Statement has become the document of most interest to contractors. Assets, liabilities, and changes in financial position are not always clearly defined in day-to-day business management, but the P and L Statement enables the contractor to instantly review all of the financial data and quickly arrive at a "bottom line" answer to their most frequently asked question.

There is one catch; the P and L Statement can sometimes mislead the contractor. The statement, unlike a cost accounting projection, does not always provide an accurate historical picture of the business and may be of little help when evaluating the direction which will be most profitable for the business in the future.

Although often used for cost assessment, this is not the purpose of the statement; it is generally prepared for either the bank or the IRS and may not provide accurate percentages and numbers for bidding or budgeting.

Also, statements vary from year to year so future cost predictions made on the basis of this information will be unreliable unless these fluctuations are calculated.

Keep in mind, P and L Statements are useful, but they are "after the fact" information reflecting only a financial standing during the year. Where a budget projection can provide an assessment for future direction, the statement offers no evaluation of what was done right or wrong during the business year.

One example of how P and L Statement information can be misleading would occur in the area of depreciation. Depreciation for tax accounting purposes does not allow for inflation. A truck purchased for $12,000 may cost $16,000 to replace five years later.

A cost budget would reflect the replacement as well as the actual costs; a P and L Statement does not.

Also, owner's salaries are only reflected by the figures tabulated for the Statement; no assessment of the real value of the 60 to 70 hours actually worked by the owner is included. Cost accounting projections more accurately reflect these and many other costs.

Contractors tend to turn the responsibility of accounting over to their representative when they should actually take a more active role in the development of a financial statement.

Their operating statement should reflect the company's practices and be closely coordinated with both estimating and purchasing procedures. The accountant will have difficulty assembling this information without the contractor's input.

Accounting can be viewed as estimating backwards with the estimate being a prediction of cost and the accounting being the actual tabulation of costs.

Accounting can be extremely time consuming and expensive. Without meaningful information constructed in a logical format, the value of the process may be diminished.

There is one catch. The P and L Statement can sometimes mislead the contractor. Unlike a cost-accounting projection it does not always provide an accurate historical picture.

Accounting for contracting and service trade businesses should include two primary expense classifications; the first is "Direct Costs" and the second is "Indirect Costs."

Direct Costs, broadly defined, are those expenses attributed to specific jobs. Indirect Costs are the categories of expenses which cannot be linked directly to a single job.

Direct Costs may be further translated as the Costs of Sales; this is a tax accounting term that can be found on most standard Profit and Loss Statements. Indirect Costs, however, may be further defined as Overhead Expenses or Operating Expenses.

For cost accounting purposes, Overhead Expenses should be further separated into two divisions: Fixed Overhead Expense and Variable Overhead Expense.

For effective cost analysis, Operating Statements should be broken down into these three categories: Cost of Sales, Fixed Overhead, and Variable Overhead. By isolating variable overhead and using tangible statistics, a contractor can better project what the business overhead would be even with long range variations in field employment.

Cost of Sales Defined

As previously stated, Cost of Sales or Direct Costs are expenses which can be charged to specific jobs. They would include such items as direct field labor, materials, specific job costs, and subcontracting.

Many of these costs are easy to identify, tabulate, and record—and they are somewhat self-explanatory.

A brief description will help develop an understanding of what items should be assigned to each category.

Direct Field Labor. This account should include wages paid to all employees actually performing the work or billing hours to the company. Highly skilled mechanics, semi-skilled workers, trainees, and working foremen as well as in-shop personnel such as a shop fabrication operator would be included in this category.

Costs should be recorded according to how the job is bid. For example, if the foreman's time is included with field labor when the job is bid, then the pay for that time should be calculated in direct field labor.

Salaries of administrative employees should not be figured into field payroll unless some portion of their time is spent performing direct field labor or working with the tools. Administrative salaries should be recorded as part of fixed overhead.

Materials. These are the actual goods and materials used on the job; they should be charged to the job only if they are a cost of that specific job. Other expenses such as freight and sales tax should also be included.

Reuseable items such as small tools, drop cloths, and ladders should not be charged to this material account, but should be considered Variable Overhead.

Special Job Costs. This category includes special expenses other than material and labor. Rental equipment expense, special travel costs, lodging for field employees and bond security would all be included.

Again these costs must be job-related and charged directly to a specific job.

Subcontracting. Expenses related to having outside companies perform a portion of the job would be included in this category. Today many subcontractors also act as prime contractors or work within the tier sub system.

Avoid charging the expense of piece workers to this account. The salary of this type of employee should be calculated into the labor account. Piece workers are employees who are paid by the unit rather than by the hour.

Fixed Overhead Defined

Fixed Overhead costs are regularly reoccurring expenses which are constant and do not drastically fluctuate with business volume or level of employment.

Although "fixed" denotes that they do not change, a more accurate description of these expenses would be "absolute necessities." Of course, these costs of doing business are essentially predictable, but some will be definite and others will be less precise.

Some examples of these costs would be rent, depreciation, administrative salaries, advertising, professional fees, and office supplies.

Variable Overhead

Variable Overhead is all operating expenses generated by the field personnel; the business would not incur these costs if no employees were working in the field.

"Variable," as the term implies, means these costs fluctuate in direct relation to the amount of labor force employed. As there are many other variable costs associated with contracting or service trade businesses, this term can be misleading.

When used in this case of analyzing the contractor's overhead costs, it refers to expenses created by field labor only. Items such as vehicle repairs and maintenance, gas, payroll taxes on field labor, hand tools, and trouble lights are considered Variable Overhead.

Benefits of Doing It Right

In summary, the contractor's accountant should serve as a professional assistant in the management of the business and not strictly as a fact-keeper for the IRS.

Time should be invested in setting up a chart of accounts that meets the needs of the company. If constructed properly, this chart will satisfy both the cost accounting and tax accounting requirements. If properly maintained, it will greatly assist the contractor in planning the future of the business. ■

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