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# Construction Accounting and Taxation

## Are Your Assets Protected?
### The Internal Controls You Should Be Implementing

### Wind Project Valuation Considerations

### The Application of Revenue Recognition Standards

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# DO YOU HAVE YOUR INTERNAL CONTROLS UNDER CONTROL?

**Safeguard assets and hard-earned profits by implementing mitigating controls or oversight where weaknesses exist.**

MARK E. LUND

During periods of peak construction and significant backlog, you need good internal controls to safeguard your assets and hard-earned profits. That is a given. But what happens during an economic downturn, when personnel start turning over, or worse, when a pandemic occurs and your accounting department becomes lean and may need to work from home? It is easy to get distracted or to make compromises during such times. And it is during such times that you can be vulnerable.

There are basic internal controls that must be in place, regardless of whether you are setting monthly revenue records or nervously watching jobs and productivity slow down while owners, developers, and contractors address the need to continue building safely and profitability. Responsibility for developing and monitoring these internal controls falls to management.

Most contractors who are reading this article probably do not have an internal audit department or internal audit function. Most do not have a treasury department that is separate from their accounting department. As you move down the organizational complexity chart to a more realistic representation of what you see in your own company, ask yourself what internal controls you should have to safeguard your assets. The following internal controls are recommended for this purpose.

## Segregation of duties

Segregation of duties is fundamental in any control environment. Many of the controls discussed later have roots solidly in segregation of duties. The basic principle: Individuals who have access to assets should not have access to the related accounting records. It sounds simple, but in practice there are challenges, mostly related to having sufficient personnel to achieve segregation of duties.

## Check signors

If individuals who can sign checks have access to the financial accounting system, there is an inadequate segregation of duties.

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The ability to sign a check provides access to assets. Any individual who can sign checks should not have the ability to enter journal entries or to access related accounting records, including accounts payable subledgers, payroll journals, and the general ledger.

At many companies, the CFO or controller is responsible for signing checks, which is often a fundamental mistake. A CFO or controller who can sign checks singly and also has access to the accounting records and system is in a position to divert cash from the company and hide or mask the transaction in the accounting records.

Depending on whether there are other mitigating controls, inadequate segregation of duties can result in a significant deficiency or material weakness in internal controls. This weakness in internal controls can be addressed by taking the following steps:

1. *Require that checks be signed by someone outside the accounting function.* In many companies, this responsibility falls to the owner, CEO, or COO, where such individuals do not have access to the financial records or system. In essence, they are serving the treasury function for the company.
2. *Limit the dollar amount of checks that can be issued singly with only one signature.* This applies in situations where, due to a limited number of personnel in upper management, the CFO or controller must have access to the accounting records and also retain the ability to sign checks. The dollar amount limit can be set anywhere based on management's evaluation of the risk and other controls. As an example, checks higher than $5,000 could require two signatures, one of which belongs to the owner, CEO, or COO. The second signature requirement limits the company's risk exposure to less than $5,000 if the CFO or controller writes a check to themselves or cashes and then hides the disbursement in the accounting records. Management should implement other oversight controls to mitigate the risk of unauthorized disbursements under $5,000 (or whatever amount they have set for their company).
3. *Give check signors read-only access to financial records.* If management deems it necessary for the CFO or controller to sign checks, segregation of duties can be achieved by giving these positions read-only access throughout the financial accounting system, so that they do not have the ability to make original entries into the system (e.g., post vendor invoices, set up personnel for payroll) or make journal entries.

The third step requires a sufficient number of other accounting personnel who have the skills and knowledge to handle their responsibilities and to recognize and decline a request to post irregular accounting entries. Require a second authorization or review for any such requests, which may include a request to post an inappropriate journal entry, a credit memo or debit memo to a subledger, or a request to set up an unauthorized vendor.

## Accounts payable disbursements

Accounts payable checks (checks to subcontractors, material suppliers, rentals, overhead, etc.) should not be returned to the accounts payable clerk, CFO, or controller once they are signed. Signed checks represent an asset of the company, subject to defalcation if returned to the individual who has access to accounting records. Separate the signed check from the voucher package and return only a copy of the check and the voucher package to the accounting department. Have the check mailed or distributed by someone outside the accounting department. If the payables clerk has access to the signature stamp for computer-generated or printed checks, require a second signature and review before mailing.

**SIGNED CHECKS REPRESENT AN ASSET OF THE COMPANY, SUBJECT TO DEFALCATION IF RETURNED TO THE INDIVIDUAL WHO HAS ACCESS TO ACCOUNTING RECORDS.**

## Payroll disbursements

The same internal control principles apply to the payroll disbursement function. Once the payroll checks are signed, they should not be returned to the payroll clerk or the CFO, controller, or assistant controller if they have access to the payroll accounting system or records. Although it can be a challenge in the construction industry, direct deposit of payroll is an excellent control as there are no accessible signed checks to be controlled. But remember, the ability to sign checks or to prepare and electronically sign checks (as a payroll clerk does) means access to an asset, even if a physical check is not issued. Implement mitigating controls or oversight where weaknesses exist. Also, review the payroll disbursements records periodically and look for "ghost employees."

### Physical distribution of payroll check

Paper checks are still common in the construction industry, with payrolls to laborers occurring weekly. While the normal process might be for the project manager or superintendent to disburse the checks in the field, it is a good control to have someone else periodically deliver and hand out those checks on a surprise basis to look for fictitious employees. It is also a good control procedure to check for field laborers who are being shaken down to pay the superintendent an amount out of each paycheck or risk being fired. Imagine a concrete laborer approaching a surprise management representative, who is handing out checks, and saying, "Here is your $20." When asked what the $20 is for, the laborer says, "We always give the superintendent $20 each week."

### Wire transfers

Segregation of duties is even more critical when it comes to wire transfers, and the same rules for segregation of duties apply to initiating and sending wire transfers of company funds. Accounting personnel who have the ability to initiate a wire transfer from the company should not have access to the general ledger and accounting system. You may be preventing fraudulent activities of less than $5,000 with controls over paper checks, but higher amounts may be at risk without controls over wire transfers.

**SEGREGATION OF DUTIES IS EVEN MORE CRITICAL WHEN IT COMES TO WIRE TRANSFERS, AND THE SAME RULES FOR SEGREGATION OF DUTIES APPLY TO INITIATING AND SENDING WIRE TRANSFERS OF COMPANY FUNDS.**

Ideally, only individuals outside the accounting department should be authorized to initiate a wire transfer. Treasury initiates and controls the transfer; accounting accounts for it. As noted previously, with limited personnel, you may need to add mitigating controls. Mitigating controls could include dual participation to initiate a transfer, with a follow-up reconciliation of the transfer log per management to the actual transfers on the bank statement. Some banks will execute the control of contacting management first to verify or approve the wire transfer.

Wire transfers can pose a higher risk than computerized or paper checks. Wire transfers invite fraudulent activities, such as when an email, purportedly from the CEO or CFO, is sent to the controller or accounting department authorizing a transfer of funds to a specific bank routing number. The emails may look legitimate, but it is only after such transfers are made that companies realize they have been scammed. Consider requiring the two-person authorization of wire transfers.

### Positive pay

Almost all major and most regional banks offer positive pay, and if you are not already using it, you should. Approved disbursements for each check run are forwarded to the bank, and the bank only clears checks included on the positive pay details. This provides another deterrent to prevent accounting personnel from issuing a check outside the normal review and control process. The positive pay process of uploading approved checks to the bank (access to assets) should not be performed by personnel that have access to the related accounting records or general ledger or have the ability to make journal entries. Discuss positive pay controls with your bank.

### Cash receipts

Customer or owner checks should be deposited by someone outside the accounting department. Only the deposit information or copies should be forwarded to accounting. Alternatively, the cash receipts (checks) should be restrictively endorsed to the benefit of the company by someone outside the accounting department, and then the checks should be sent to accounting for depositing and recording. Checks that are restrictively endorsed (e.g., For Deposit Only. ABC Construction Inc. Acct. #458723) are much more difficult to divert to another bank account or turn into cash.

## Electronic receipts

Setting customers or owners up to use wire or electronic transfers to make payments on monthly billings or draws on the project eliminates the need for multiple company personnel to handle owner receipts before depositing under the normal segregation of duties. This way, funds are company property and secure in the bank account without any personnel having access to them. Your internal controls over cash are now limited primarily to the cash disbursements function, and you greatly reduce the risk related to handling owner remittances before they are recorded.

## Bank account reconciliations and other cash controls

Bank accounts should be reconciled monthly on a timely basis. Ideally, the reconciliation should be completed by an individual who does not handle the related accounting records or related assets. For example, the accounts payable disbursement bank account could be reconciled by the accounts receivable accountant. All bank reconciliations should be reviewed by someone other than the preparer, and their review should be documented by initialing and dating the review.

An excellent internal control procedure over cash is to have an individual in management who is not in the accounting department review the electronic bank statement activity each month before accounting does its bank reconciliation. For smaller contractors, the best person may be the owner or a shareholder who is familiar with the operations of the company. Spending 15 minutes to review the electronic copies of checks clearing the bank each month (as well as wire transfers out) provides a wealth of information on where the cash goes each month and brings to light unusual vendor or subcontractor names on checks.

Larger contractors may assign monthly review of bank activity to the COO or another shareholder. The key point is that all accounting personnel know management is conducting a monthly review of bank activity. In reality, the threat of an ongoing monthly management review is often a sufficient deterrent to dissuade accounting personnel from attempting an unauthorized disbursement. Therefore, missing a month of review is not a critical failure. The fact that personnel believe there is a monthly management review is in itself a type of control.

## Cost shifting by project managers

When a project is going badly, project managers may have an incentive to shift costs to another job. This could be a one-time shift in which the costs are permanently hidden in the second job and not discovered, leaving the contractor with two jobs with incorrect costs and gross profit numbers. On the other hand, the shift could be temporary. Costs from Job A are moved to Job B; when Job B starts running over budget, those costs are moved to Job C, and so on.

To control the shifting of costs, require that materials purchases delivered to an address other than the stated project number address are pulled and questioned. Additionally, have a second sign-off or review for requests by project management to move costs from one job to another, verifying the supporting documentation or evidence of the incorrect initial coding.

**THE THREAT OF AN ONGOING MONTHLY MANAGEMENT REVIEW IS OFTEN A SUFFICIENT DETERRENT TO DISSUADE ACCOUNTING PERSONNEL FROM ATTEMPTING AN UNAUTHORIZED DISBURSEMENT.**

## Kickbacks from subcontractors and suppliers

One of the most difficult fraudulent acts to uncover occurs in the field, when a project manager arranges for a kickback or favors from a subcontractor in exchange for being awarded the subcontract. To keep project managers from getting too cozy with subcontractors, require a minimum of three bids for all the prime subcontracted areas. Maintain bids in the bid file, with supporting details about each subcontractor. Continual selection of a subcontractor who is not the lowest bidder should give rise to questions by upper management or the COO. Additionally, an unusual amount of change orders to that subcontractor on a continuing basis over several projects may indicate a revenue recovery facilitated by the project manager on the subcontractor's initial low bids.

ESTABLISHED BY UPPER MANAGEMENT AT THE BEGINNING OF THE YEAR, ANY OVERHEAD ACCOUNTS THAT ARE OVER BUDGET SHOULD TRIGGER A MANAGEMENT REVIEW OF DETAILS OF THE EXPENSES.

## Internal project audits

Since the project manager controls so much of a project's activity, from bid date to substantial completion, an effective control is to have another project manager conduct periodic internal audits. The other project manager reviews bid files, subcontracting activity, job cost detail, change order activity, areas with cost overruns, areas with significant savings, and final gross profit margin. Any items that appear abnormal or outside expectations should be investigated further. Such reviews by a second project manager should dissuade primary project managers from abusing their authority over project expenditures, change orders, and final contract amount and margin. The second project manager can also review in detail and question cost overruns on a particular phase of a project.

## Budgets

Budgets are an effective tool for controlling overhead expenses. Established by upper management at the beginning of the year, any overhead accounts that are over budget should trigger a management review of details of the expenses. The review will prevent project managers from trying to make their project look better by moving costs out of their project and into overhead. Many times, these cost overruns show up in payroll-related accounts, supplies, and other contracted services normally reserved for the general office overhead.

## Vacation policy and rotation of responsibilities

A vacation policy that requires all employees to take time off each year is another good internal control for contractors. Fraud is often exposed when the perpetrator is not there to cover it up. Even if a loyal employee claims not to need a vacation, it is a good internal control procedure to require all employees to take at least two weeks vacation.

Vacations should be taken for two consecutive weeks and overlap with several payables, payroll, and billing/receivable periods. Having another employee managing these tasks during a regular employee's vacation may be a sufficient control to deter someone from embezzling company funds.

A mandatory vacation policy is also important from a firm risk management perspective. You need to have another accountant in the department cross-trained for each function. Should a key employee leave for health or other unexpected reasons, you do not want to be without someone who can take over that position and continue to process payables, payroll, or billings. Be sure to turn software access controls on and off as appropriate.

## Simple internal audit procedures

Most accounting systems will easily download details from the accounts payable subledger into Excel. A very simple procedure that is effective for smaller contractors to give management a quick view is to download all cash disbursement from the payables subledger. Sort the download by the following criteria:

1. *Check number.* Look for missing check numbers or gaps in check numbers. Compare checks to the bank statement to be sure none of those missing checks cleared the bank, indicating disbursement fraud or masking an unauthorized cash disbursement.
2. *Highest to lowest amount.* Scan the list for larger checks paid to a vendor or subcontractor that you are not familiar with.
3. *Payee or vendor name, ranked largest to smallest.* Scan the list for unusually large amounts paid to someone outside their normal volume. Look for higher amounts paid to someone you do not recognize.

Lastly, sort or search checks for checks payable to either cash or to the names of employees in the accounting department. Employees should not be receiving checks except for expense check reimbursements and normal payroll amounts, and there should not be checks payable to cash. Once these details are downloaded into Excel, the management review process takes just a few minutes each month. A similar exercise can be done for the payroll disbursement account and the job cost subledger.

## Conclusion

The aforementioned controls are some of the most common controls for any contractor, even those that do not have an internal audit department. Obviously, there are cost benefit considerations to any control, but the basic segregation of duties on cash disbursements and cash receipts is fundamental and should be implemented whenever possible.

Some of the procedures discussed can be implemented at the same time or over time as you fine-tune segregation of duties. Procedures such as internal audit disbursement tests can be rotated on a monthly or quarterly basis. The element of uncertainty in applying internal control procedures is a great control as well.

You have worked hard to earn those profits. Implement controls to protect them! ■