

Senate Transportation Committee Hearing – Modernizing Financial Statement Requirements

The State Highway Law requires PennDOT to establish, by regulation, a system for qualification of competent and responsible bidders on highway projects. In determining the qualifications of bidders, the State Highway Law specifies that PennDOT shall consider the following factors relating to the contractors: (1) equipment, (2) past record, (3) experience, (4) personnel of the organization, and (5) financial condition. In determining the qualifications of newly organized bidders, the State Highway Law specifies that PennDOT shall consider the following factors relating to the newly organized contractors: (1) equipment, (2) personnel of the organization, and (3) financial condition. As per the State Highway Law, PennDOT shall not consider bids from any bidder who is not qualified.

Title 67, Chapter 457, entitled Prequalification of Bidders, implements this portion of the State Highway Law by providing a method and manner for the processing and evaluation of the capacity and qualifications of contractors and subcontractors to perform highway project work. The regulations of Title 67, Chapter 457 assure the integrity, responsibility, and competence of bidders.

To determine the financial condition of a bidder, as required by the State Highway Law, Title 67, Chapter 457 requires the certification, rendered with an opinion, by an independent certified public accountant, public accountant, or foreign accountant registered in accordance with the C.P.A. Law, as to the financial condition of the prospective contractor. Because of this regulation, PennDOT can only accept audited financial statements or reviewed financial statements and cannot accept compiled financial statements. The following summarizes each type of financial statement:

- **Audited Financial Statement** – Provides the user with the auditor’s opinion that the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework; the auditor may also issue a disclaimer of opinion or an adverse opinion, if appropriate. In an audit, the auditor is required to obtain an understanding of the entity’s internal control process and assess fraud risk according to Generally Accepted Auditing Standards (GAAS). The auditor is also required to corroborate the amounts and disclosures included in the financial statements by obtaining audit evidence through inquiry, physical inspection, observation, third-party confirmations, examination, analytical procedures, and other procedures.
- **Reviewed Financial Statement** – Provides the user with comfort that the accountant, based upon their own review, is not aware of any material modifications that should be made to the financial statements; thus, the financial

statements are in conformity with the applicable financial reporting framework. In a review, the accountant designs and performs analytical procedures, inquiries, and other procedures as appropriate; based on the accountant's understanding of the industry, knowledge of the client, and awareness of the risk that he or she may unknowingly fail to recognize financial statements that are materially misstated. A review does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records; or other procedures ordinarily performed in an audit. A review is substantially narrower in scope than an audit and reports that the auditor is not aware of any material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework.

- **Compiled Financial Statement** – Represents the most basic level of service with respect to financial statements. In a compilation engagement, the accountant assists management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures ordinarily performed in a review. The accountant does not gain an understanding of the entity's internal control or assess fraud risk, test accounting records, or complete other procedures ordinarily performed in an audit. Accordingly, the accountant does not express an opinion or provide any assurance about whether the financial statements are in accordance with applicable financial reporting framework.

In short, audited financial statements are the most costly to contractors but present the least amount of risk to the Commonwealth because the level of evaluation and analysis is the most in-depth and detailed of the three types of financial statements. Conversely, compiled financial statements are the least costly to contractors but present the greatest amount of risk to the Commonwealth since the process is little more than "self-certification" by contractors, as opposed to independent certification by accountants.

In addition, the overall results of a financial statement are then the basis used to establish a contractor's "maximum capacity rating". In general terms, the maximum capacity rating is the total value of contract work that PennDOT can award to a contractor at any point in time. For example, if a contractor's maximum capacity rating is \$500,000 and PennDOT awards a \$400,000 contract to this contractor, this contractor is only eligible for additional contracts with PennDOT that, when combined, do not exceed the remaining \$100,000 of available capacity. However, as this contractor completes the \$400,000 contract, the available capacity will increase accordingly.

Title 67, Chapter 457 defines a formula for determining a contractor's maximum capacity rating. This formula considers a contractor's net working capital, line-of-credit statements, book value of equipment, and an "ability factor" that is assigned by PennDOT that is used as a multiplier. Net working capital is defined in Title 67, Chapter 457 as "current assets less current liabilities". The assigned ability factor can range from between 1 and 15; 6 is assigned to new contractors.

$$Q = F (C + \frac{1}{2}L + \frac{1}{2}E)$$

Q = Maximum Capacity Rating

C = Net Working Capital

F = Assigned Ability Factor (1 to 15; 6 is assigned to new contractors)

L = Line-of-Credit Statements

E = Book Value of Equipment

Since reviewed financial statements present a greater risk to the Commonwealth than audited financial statements, by regulation, PennDOT only accepts reviewed financial statements from contractors that have a both a net working capital of between \$0 and \$50,000 and a maximum capacity rating up to \$4 million. If the net working capital is between \$0 and \$50,000 but the maximum capacity rating exceeds \$4 million, a reviewed financial statement is not acceptable, and an audited financial statement is required.

The following example illustrates the importance of determining the financial condition of bidders, based on an actual contractor that is prequalified by PennDOT:

When PennDOT reviewed the audited financial statement, this contractor was determined to have a net working capital of -\$400,000 (meaning liabilities exceed assets), no line-of-credit-statements, and a book value of equipment of \$600,000. As a new applicant, PennDOT assigned the number 6 as the contractor's ability factor. By using this data, the maximum capacity rating was determined to be -\$600,000 under Title 67, Chapter 457.

This contractor's financial condition indicates that it should not be eligible to bid on PennDOT's projects when objectively compared to other prequalified contractors that have demonstrated a sound financial condition. This contractor would still be eligible to work on PennDOT's projects as a subcontractor, but any bid that it submits to PennDOT as a prime would be rejected because of its negative maximum capacity rating.

In contrast, if this same contractor were to eliminate the negative working capital to reach a balance of assets and liabilities, it would have a maximum capacity rating of \$1.8 million and could submit bids and be awarded contracts that do not exceed this amount.

PennDOT reviewed SB 1181 from the 2015-16 Legislative Session and has three, primary concerns associated with the changes that it presents to Title 67, Chapter 457:

1. Firstly, accepting compiled financial statements presents the greatest risk to the Commonwealth since the accountant's role is limited to receiving financial data from a contractor and presenting this data as a financial statement without any analysis and certification. A contractor that would be ineligible to bid because of a negative maximum capacity rating under Title 67, Chapter 457 would now be eligible to bid at great risk to the Commonwealth as long as it submits a compiled financial statement. If compiled financial statements are determined to be an acceptable risk to the Commonwealth, PennDOT would recommend that limitations be included that are consistent with the language of Title 67, Chapter 457, similar to the limitations that are specified for reviewed financial statements, in order to mitigate this risk.
2. Secondly, SB 1181 appears to arbitrarily assign a maximum capacity rating of \$1 million to any contractor that submits a compiled financial statement, regardless of a contractor's net working capital, assigned ability factor, line of credit statements, and book value of equipment. PennDOT considers the treatment of this type of contractor to be unequal when compared to other contractors that are evaluated under Title 67, Chapter 457. If compiled financial statements are determined to be an acceptable risk to the Commonwealth, PennDOT would recommend that net working capital, assigned ability factor, line of credit statements, and book value of equipment still be considered when determining the maximum capacity rating in accordance with Title 67, Chapter 457 instead of assigning a maximum capacity rating without considering these factors.
3. Lastly, SB 1181 abrogates a significant portion of Title 67, Chapter 457 that extends far beyond the financial statement requirements. If the financial statement requirements under Title 67, Chapter 457 are changed by legislation, PennDOT would recommend that only the regulatory portions associated with financial statements be abrogated and replaced with language that is consistent with Title 67, Chapter 457.

Although there are concerns with SB 1181, PennDOT does recognize the need to comprehensively evaluate and improve Title 67, Chapter 457, including financial statement requirements. During 2017, PennDOT plans to research the best practices of other states so as to determine if these practices can be adapted for Pennsylvania. In addition, stakeholder groups, such as the Associated Pennsylvania Constructors (APC), the PA Office of the National Federation of Independent Businesses (NFIB), minority-owned businesses, and the Pennsylvania Turnpike Commission, will be engaged to provide input on improvements to PennDOT's contractor prequalification processes. These plans were endorsed by the State Transportation Innovations Council (STIC) in 2016. It is anticipated that one outcome will be recommended improvements that can be

quickly incorporated within the existing State Highway Law and Title 67, Chapter 457. For recommended improvements that require revisions to Title 67, Chapter 457, the outcome will be proposed regulations to follow the Regulatory Review Process for consideration. For example, one such improvement could be to increase the threshold for reviewed financial statements and to introduce requirements for compiled financial statements.