



CFBL
CONSULTING

OPEN BOOK ACCOUNTING IN A CHALLENGING ECONOMY

Guidance for Alliance and Cost Based Contracts



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WHAT IS OPEN BOOK ACCOUNTING?

“ Open book accounting is used for sharing risks, gains, and cost savings. It requires full transparency with cost, profits and access to all cost systems. This means that records need auditing by an independent third party. In challenging times when risks increase, transparency will reduce, so using data analytics, applying a risk-based audit approach and judgment is vital ”

WHAT IS OPEN BOOK ACCOUNTING

- The process of procuring work where contractors are paid on the basis of transparent accounting records showing cost, rate, budget, overheads, fee and profit build-up is called open-book accounting.
- This is typically used on incentivised alliance and cost-based contracts on construction projects. The parties collaborate, share gains, savings, and collectively identify risks for profit / value creation.
- Buy-in to this principle of transparency by the contractors, and subcontracts who may even be engaged on a fixed price basis, and further down the supply chain to all parties on the project is key.

12 GLOBAL ECONOMIC INDICATORS

Below we have listed 12 global indicators to evidence that we are indeed in challenging times globally.

- Global PMI a 50.3 decrease - IHS Markit & JPMorgan's snapshot of global manufacturing
- Euro-Area a 9.1% increase in inflation - a measure watched by the European Central Bank
- US employment a +315K decrease - a measure of labour in the world's largest economy
- U.S. consumer spending a 0.4 % increase - mainly one of the pillars of the world economy.
- U.S. personal consumption expenditure +6.2% decrease Federal Reserve measure of inflation.
- Brazil's GDP +3.20% increase - a proxy for commodity exporters throughout the world.
- Chile copper exports a \$3.27M decrease - Andeans are the largest copper producers.
- German Ifo is unchanged at 88.6 - the leading indicator of health of Euro lynchpin economies.
- China's manufacturing PMI is 49.4 up an insight from the world's largest global manufacturer
- China PPI +2.3% decrease - Cost charging at China's factories indication of global inflation.
- Japan's Inflation +2.8% increase - a measure of price pressures and fiscal monetary measures
- South Korea's Exports - insight into demand for Asia's key exporters especially for technology.

Source: Bloomberg.com



HOW OPEN BOOK PRINCIPLES SHOULD BE CORRECTLY APPLIED?

“

In several cases, despite being a contractual requirement, open book audit clauses are ignored until much later or until final accounts when it is too late to influence outturn costs or they are circumvented altogether. It is vital for the parties to agree on controls and protocols for administering the open-book clause early on before cost escalations begin.

”

- There are no standard industry guidelines on how and when costs should be audited, so communicating a cost assurance strategy to the supply chain early is key. This entails clear protocols at project inception for sharing and using sensitive commercial data and pre-agreeing a representative cost effective sampling approach.
- This includes the level of expected scrutiny, records required, and GDPR protocols for controlling data from financial systems and payroll systems. Contractors and subcontractors must buy-in and agree to grant secure access to confidential costs, records, and accounting systems.
- Pre-agreeing how costs should be built-up, allocated, and reported is vital. Engineering construction contracts ICC, NEC, and JCT forms have standard formats stating defined costs, actual costs, or disallowed costs but do not specify methods for cost build-up. Defence and energy contracts require skills for additional scrutiny and regulation of costs.



GUIDELINES FOR OPEN BOOK PRINCIPLES

- Communicating the strategy to the supply chain
- Training the staff/teams involved in open book
- Ensuring the systems are set up for the contract
- Enforcing contractual open-book audit clauses
- Establishing standard open-book protocols early
- Signing GDPR /non-disclosure agreements early
- Ensuring that open book is not used punitively
- Reporting costs correctly as per the contract
- Safeguarding commercially sensitive data
- Training the supply-chain on open book clause



WHAT ARE THE CHALLENGES OF REALISING OPEN BOOK BENEFITS?

“Open-book must be used for the right reasons and as a strategy for the right type of projects. It is particularly useful for large complex infrastructure projects with significant risks. Open book clauses must be correctly applied by the parties. This entails using sensitive data as intended to achieve the common goals, share gains, cost savings and realised value as planned.”



- Cost efficiencies can be realised through targeted gain-share incentives and shared risks.
- Value from investments can be increased by using open-book accounting to optimise costs.
- Evidence can be used to predict issues, for corrective action, and for commercial negotiations.
- Data can be used to monitor spending and to challenge costs increases ahead of final accounts.
- Evidence can be used for contract evaluations to validate pain-gain-share and incentivized payments.
- Collaborating to resolve issues will build long-term relationships that will boost future revenue.
- Lessons on conclusion of each audit should inform future decisions e.g. people, time and productivity.

GUIDELINES TO REALISE OPEN BOOK BENEFITS

- Using open book correctly for the right reasons
- Setting up processes for shared economic risks
- Communicating plans early to the supply chain
- The parties must not circumvent audit clauses
- Not waiting until final accounts before auditing
- Aligning strategic interests of parties involved
- Jointly managing pressure from unforeseen risks
- Not using access to sensitive data punitively
- Ensuring correct leadership/people behaviours
- Training of teams/parties involved in open book
- Managing the right behaviours to ensure buy-in.



WHAT ACCESS TO RECORDS AND COST SYSTEMS ARE REQUIRED?

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Open book accounting requires an independent team with expertise in data capture, data analytics, cost systems, financial and commercial controls. Also knowledge of construction contract and audit experience are key. Due to sensitive data e.g. pay and employment records, an independent third (line of the defence) audit team is best placed to be objective.

”

- Due to the commercial and personal sensitivity of data and records that auditors have to access, contractors and subcontractors require signing a non-disclosure separate to the contract.
- General Data Protection Regulation (GDPR) rules of 2018 also means there are strict legal rules around ownership, access and control of personal data and how these must be used fairly and kept secure.
- Using an independent third party is necessary as project teams frown at the employer team having access to payroll data. An independent team can report without influence on major issues identified.

INDICATIVE LIST OF RECORDS & SYSTEMS

- Access to cost capture/reporting systems
- Access to raw financial systems data
- Access to a chart of account & cost codes
- Staff, rates, payroll, expenses & payments
- Labour rate, payroll, expenses & payment
- People employment & insurance records
- Records of project and overhead time
- Plant time records, rates & operatives
- Material rate, storage & payments
- Cost reports of actual and forecast
- Contract, changes, and variations
- Cost reports and supporting records
- Cost application and supplier payments
- Purchase Order, Invoices & agreements
- Subcontract cost, agreement & payment
- Design cost, agreement, time & payment
- Risk, early warnings & change registers
- Contract appendices and rate build-up
- Asset register for plant and materials
- Overhead cost and time allocation
- Rebates, credits, and volume discounts
- Overhead fee, contract fee & calculations
- Applied for cost and supporting records
- Intercompany agreements and rates

This indicative list is not limited to the above.



HOW TO MINIMISE DISALLOWED COSTS IN CHALLENGING TIMES?

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Communicating the cost assurance strategy and audit programme early to the parties and the supply chain is key. This will ensure that from the start the right behaviours and tone are set. This includes ensuring that cost reviews or assurance engagements and audits are initiated for the right reasons with timely access to cost records provided.

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- Minimising disallowed costs early involves ensuring that commercial, finance, and project teams are trained in advance on the protocols and contractual knowledge needed for open-book clauses.
- This includes the right behaviours and robust control systems to provide confidence to funders and clients on the effectiveness of contract controls. and providing timely access to records and systems.
- Ensuring also that the financial systems hierarchy of accounts are set up to correctly administer the contracts , open book clause and that there is transparency on build-up of rates, fees, and profit.

DISCUSSIONS TO MINIMISE DISALLOWED COSTS

- Timely notification of early warning notices
- Jointly reviewed risk and change registers
- Joint clarity on allowed cost in rate build-up
- Joint clarity on overhead cost and time
- Timely approval of variations and change orders
- Pre-agreeing staff rate & resource changes
- Pre-agreeing labour rate & resource changes
- Pre-agreeing subcontract rate/resource changes
- Pre-agreeing plant rate & operatives changes
- Pre-agreeing design rate & resource changes
- Agreeing on ownership of unforeseen risks
- Working collaboratively to save costs
- Working collaboratively to drive value/efficiency



HOW TO MANAGE OPEN BOOK IN A CHALLENGING ECONOMY

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Leveraging existing or new technologies, giving secure access, and deploying a risk-based approach can be used to manage open book principles in a challenging economy. Early dialogue, and setting up control systems and records will make contract cost reviews, assurance, and audits more efficient and will ensure that correct records exist when things go wrong and there is dispute or litigation.

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- In challenging times, the parties to a contract will probably review the contract and quickly come to the conclusion that, except in cases of a serious breach, termination is unlikely to be the best remedy. Nevertheless, contracts should include specific termination right. This is an extremely crucial clause in the contract.
- The most likely solutions are, initially, a degree of escalation through commercial governance arrangements on the contract to take it to the next level, the board or the Chief Executive level. This also needs to be supported by remedies via a payment performance regime.
- Typically these are key performance indicators and performance payment deductions; however, also frequently, we have seen evidence of the use of cash withholding, and profit holding back further negatively impacting the supplier's performance.



DISCUSSIONS ON MACROECONOMIC RISKS

- Interest rate/inflation increases and fluctuations
- Global inflation impact on raw material cost
- Inflation and export impact on plant cost
- Global manufacturing impact on project costs
- Discussing the effect of project labour shortages
- Increasing staff costs salary & expenses increase
- Renegotiating untenable fixed-cost contracts
- Effect of global inflation on goods & material costs
- Increase in import costs e.g. copper for wiring
- Strength of Euro/GBP currencies and economies.
- Inflation, export & manufacturing charges in Asia
- Cost of scope variations and extension of time
- Early collaborating to avoid contract termination
- Working collaboratively to manage economic risks



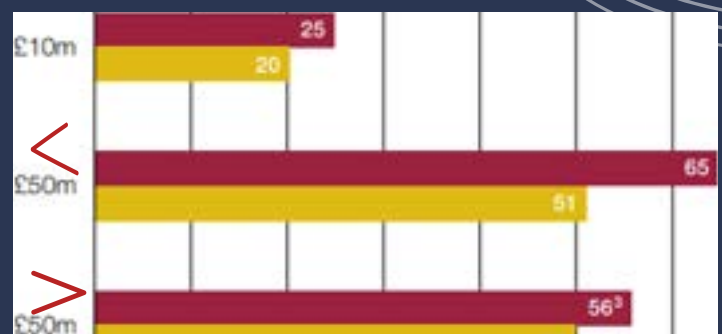
GLOBAL TRENDS OF OPEN BOOK ACCOUNTING IN CONSTRUCTION

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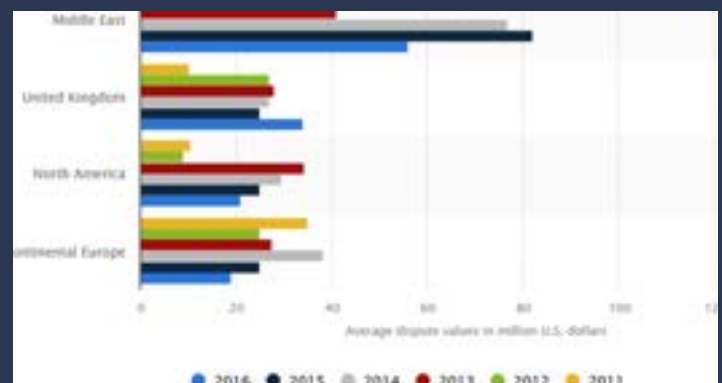
Open book accounting on infrastructure projects requires an independent team with expertise in data capture, analytics, knowledge of construction contracts, financial and cost systems, and audit experience. Including the ability to apply judgment and a risk-based approach to assurance on infrastructure projects.

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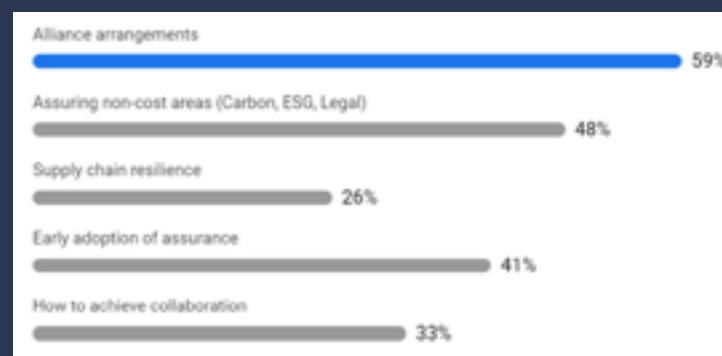
- In the UK, the Ministry of Defence has been using open-book accounting for a longer period of time than other government bodies. According to a survey by the National Audit Office, 31% of contracts have provisions permitting government to obtain open-book data of high value contracts </>£50m 65%/56% have open-book clauses.
- In the US, open book principles are applied on cost-plus contracts where contractors are reimbursed for allowed costs plus a profit. Cost-based contracts differ from fixed-price contracts where contractors are paid a fixed amount regardless of incurred costs. Risks largely sits with the contractor resulting in claims and disputes. From the data above, Asia / Middle East which mainly use this form have the highest disputes.
- In a challenging economy where risks are heightened, open book cost-based and alliancing contracts allow for risk and gains to be shared. In a July 2022 poll by the multi-disciplinary cost assurance steering group, 59% stated that guidance on protocols for open book alliance arrangements and carbon costs as top priority.



Source: NAO Percentage of Contracts with Open Book Clauses



Source: Statista Global Disputes on Construction Contracts



Source: Multi-disciplinary Cost Assurance Steering Group Poll



HOW CAN OPEN BOOK HELP WITH CARBON & ESG CHALLENGES?

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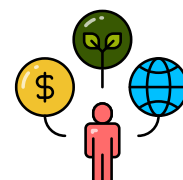
Concerns about if the transparency of data being reported by businesses can be relied on by investors and stakeholders are creating increased global compliance requirements (such as the ISSB, TCFD framework and Z clauses in NEC contracts. Open book audits enable real-time audit, review, and independent reporting of non-financial sustainability and ESG metrics.

”



GUIDELINES USING OPENBOOK FOR ESG METRICS

- A rise in Greenwashing, a practice where businesses inaccurately portray the extent of their green credentials is clearly not a sustainable practice.
- For many businesses, the challenge of ESG reporting is data and not the application of frameworks like the UN, SDs , ISSB, TCFD or other relevant standard.
- The difficulty is in gathering sensitive comparable benchmarking data, the practicalities of capturing the data and applying these to key business metrics.
- Using independent audit to deter greenwashing
- Collecting sustainability data/evidence
- Highlighting potential threats and opportunities
- Flagging weaknesses and mitigating ESG risks
- Taking advantage of opportunities early on
- Coordinating internal, ESG, cost & external audit
- Identifying weaknesses in governance regimes
- Flagging environmental greenhouse gases risks
- Highlighting carbon cost and social impact risks
- Flagging risks to long-term business viability
- Controls for potential threats and opportunities
- Using the triple-bottom line approach
- Incorporating ESG into CSR initiatives
- Including ESG in balanced score card reports



FREQUENTLY ASKED OPEN BOOK QUESTIONS (FAQS)

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Questions are often asked about open book limitations. For example open book will require upfront time and resource investment. With the right behaviours, the long-term strategic value, financial and commercial benefits are huge. Data from the audit will provide robust evidence to influence decisions in real-time and data to influence future project cost decisions.

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- Why are cost assurance audits needed? They provide real-time evidence of cost certainty/risks.
- Why is cost assurance important? It helps with achieving commercial & financial strategic goals.
- Why is an initial risk assessment fundamental? It is a key to an efficient risk-based audit approach.
- What competencies are vital for cost assurance? Data analytics, audit, judgment, cost and contract
- How does technology help? By storing records, data capture, analytics, audit and reporting
- Why are GDPR, privacy, and confidentiality key? It involves sensitive personal & commercial data.
- What vital issues are often identified? Incorrect profit, overhead assumptions & unforeseen risks
- What is best practice cost audit? It entails contract, cost, people, process, system & sustainability controls
- What are best practices for people behaviour? Buy-in, transparency, data access & contract compliance.
- What a typical cost audit cycle entails? A programme, contract, cost, people, process, systems, and controls
- How can lessons learned and technology be used? To inform future rates, people & data-led cost decisions.
- What is the outlook for cost assurance audits? Using technology for data analytics, efficiency and reporting
- What are the emerging issues for cost assurance? ESG supply chain, carbon & people cost risks will increase.
- How are cost/alliancing contracts being used? They are being used for strategic delivery, sharing risks & gains

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INFRASTRUCTURE PROJECT SERVICES

- Pre-audit diagnostic
- Cost & forensic final account audits
- Rolling programme and audit team
- Cost assurance protocols training

ESG & SUSTAINABILITY SERVICES

- Independent carbon cost & ESG audits
- Investment modelling/business case
- ESG data analytics, tax and reporting
- Finance & strategic business advisory



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