Seeking to increase your domestic home warranty limit or construction supplier register accreditation?

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At the time of writing this article we note that many of our residential and commercial builder clients are pushing for increases in their preapproval limits. In ordinary circumstances, builders who are looking to grow their revenues must be preapproved to do so. This year, whilst the usual growing businesses are looking for annual increases, we also note that COVID lockdowns and supply chain issues has also prolonged building timeframes, such that for residential builders in particular, the value of allowed work "on-site" can be consumed by jobs that are taking longer to complete than in ordinary years. As such this puts pressure on being able to sign up new customers in the short term. In this article we remind readers of the reasons behind each scheme, how the relevant authorities administer the schemes and what you can do to maximise your prospects of gaining a higher preapproval limit.

Domestic Home Warranty Insurance (DHWI)

All State and Territories have versions of the scheme operating in their regions. For residential builders, they are often accredited with a maximum amount of works as well as a largest single contract value amount. For example, they might be approved for $10m of works, with the largest single building contract value being $1m. It is through the provision of this cap that the insurer effectively mitigates their risk, by ensuring that those builders that they underwrite insurance for are not undertaking more work than their financial position ought to justify.

What does it effectively do?

The scheme acts to effectively put a rolling cap on the value of jobs that can be on site at any point in time. When builders are working with a potential new customer, they do a building estimate etc. and provide a quotation to the customer for their build, but before the job is actually commenced, the customer build contract is to be completed under which DHWI must be provided to the customer as part of the contract documentation. Where a residential builder has already reached their DHWI maximum limit, it therefore means that they cannot commence any new works until one or more of the jobs currently on site is completed & the required headroom for the new build contract value is sufficiently created.

How is it assessed?

Whilst there are a range of factors that they look to (profitability, years in business etc.) essentially the main criteria revolves around the strength of the "Net Tangible Assets" of the business. That is what are total assets (excluding intangibles such as goodwill) net of all liabilities. Ordinarily the range of the DHWI limit awarded will vary between 5% and 10% of the net tangible assets on hand at 30 June each financial year. As such, if Net Tangible Assets are $500k, then a builder may be awarded between $5m (where the NTA of $500k represents 10%) and $10m (where the NTA of $500k represents 5% of the amount awarded). Where you sit on this spectrum will depend on other factors.

Construction Supplier Register (CSR)

This applies to commercial builders and again each State or Territory has their own system as well as a National System applying to those of significant size. Unlike DHWI which applies to put a rolling cap on the amount of works on site at any point in time, the CSR accreditation is essentially an accreditation of the largest individual job value that they authorise a commercial builder to tender for in relation to Government projects. So a commercial builder with $10m CSR prequalification limit could potentially win and complete many jobs up to $10m in size and hence record annual revenues well in excess of this $10m limit.

What does it effectively do?

Like the DHWI scheme the CSR preapproval is set at a level to ensure that Commercial Builders do not put themselves under financial stress by undertaking works beyond their financial means. Whilst Government Authorities absolutely look to the CSR before including commercial builders on tender proposals for government jobs, private developers can also access the CSR and will look to the preapproval limits set for commercial builders that they are looking to engage with for private jobs. As such, a CSR preapproval limit is often a requirement for any commercial builder looking to take on a sizeable job.

How is it assessed?

Like the DHWI there are a range of tests and whilst the Profit and Loss Statement is reviewed, again it is the 30 June Balance Sheet that dictates much of the outcomes for applicants.

- **Test 1:** Construction Related Turnover: To be at least twice the preapproval limit being sought
- **Test 2:** Tangible Net Worth: Tangible Net Assets to be positive and preferably equal to 4% of actual turnover
- **Test 3:** Working Capital: Net Current Assets to be positive and preferably equal to 10% of reapproval limit being sought
- **Test 4:** Current Ratio: Current Assets to Current Liabilities must be 1.0 or greater

In this case all 4 tests are applied and most of the focus comes to tests 2 and 3 as generally speaking if you pass test 3, test 4 will also be passed.

So how can I maximise my chances of getting the approval I am looking for?

Given that we know that both the DHWI and CSR approvers are essentially looking at the strength of the balance sheet of the builder, it stands to reason that whatever can be done to strengthen the balance sheet prior to the end of the financial year will result in a better outcome for the builder. As such, as our clients approach the end of each financial year, we model the impact of continued profitable trading as well as other arrangements (i.e. can the owners inject further cash, can they delay dividends until after 30 June etc.) to ensure that we understand what the 30 June balance sheet is going to look like and hence what preapproval limits we are likely to get for the following income year. This highlights of course that good planning can result in better outcomes.

For those that do not have or utilise such forecasting tools, what else can be done to get a better outcome? The answer is presentation, presentation, presentation.

To explain, when builders engage their accountant to prepare a set of financial statements and tax returns, they dutifully proceed to ensure that the computation of taxable income is correct, and that the client remits the required amount of tax to the ATO. This however is a process to ensure that the ATO is left satisfied and that the builder (taxpayer) has remitted their fair share to tax revenues. For almost all clients however, we note that there are usually differences between accounting treatment of transactions and the tax treatment of transactions. Further, that it is the accounting treatment (and not the tax treatment) that is immortalised each year in the financial statements for clients, which are then utilised by DHWI, CSR as well as financiers.

To take a simple example, assume on 1 June a $200k asset was bought in the last year and has been fully expensed for tax purposes which of course lowers the builders taxable income and hence tax payable. However, for the purposes of financial statement preparation the asset could be expensed in full through the P&L resulting in a lower profit and lower balance sheet (as cash has deteriorated noting the $200k has been used to purchase the asset) or alternatively the purchase could have been processed as funding a new depreciable asset on the balance sheet which sees cash reduce by $200k but a new asset rising for the same $200k at this point net nil to the balance sheet (and still proceeding with the instant asset claim for tax purposes).

When comparing the scenarios, the 1st approach would see net assets reduce by $200k and hence a residential builder would lose $2m-$4m in their DHWI limit or a commercial builder could lose $2m-$5m in their CSR preapproval. Whereas under the 2nd approach, the net tangible assets remain largely unaffected (granted 1 months of depreciation should still be processed) with minimal impact applying to the residential builder and for the commercial builder Tangible Net Worth remains unchanged.

Importantly, accountants and builders cannot simply make up the data that is presented. Accountants have ethical requirements, tax agent charters and professional codes of conduct to follow. Similarly, builders have taxpayer charters to follow.

Clients who have their financial statement audited annually will be required to follow Accounting Standards and those that are not required to be audited usually follow what can be referred to as Generally Accepted Accounting Principles (GAAP). This does not mean however that there is only one way to present the financial performance for a building business in any given period. Accounting for Work in Progress and/or Income in Advance can be assessed differently from year to year under the ATO guidelines. Whether to fully expense a payment, or record part of that same payment as being a prepayment for services to be used in the following income year will impact the relative strength of a builder’s balance sheet . . . and the list goes on.

In short, there is a requirement to complete your tax returns using ATO guidelines and tax legislation, these same guidelines can provide a broad array of recorded outcomes for a client in any income year. As such, for a client looking to grow it is important to engage in the process with your advisor to ensure that you are putting your best foot forward for preapproval (ensuring your financial statements are prepared to your advantage and can withstand scrutiny) whilst ensuring that you comply with your tax obligations. Carefully working through your particular circumstances with a Property & Construction specialist advisor might be a good place to start.