EXAMINING YOUR FINANCIALS

ASK THE EXPERTS

Industry leaders provide advice about planning for smart growth, obtaining adequate bonding, protecting your balance sheet and more.

BY JEANA DURST

Q: What's the biggest piece of advice you would give company owners about how to work effectively with their construction financial managers, CFOs or accountants?

Make sure you both understand each other's jobs, and communicate project details effectively. If the CFO doesn't have an adequate understanding of the budget-to-actual-contract performance, it's impossible to estimate or report financials accurately or aggressively manage cash flow. Job performance is based on projections that are inherently subject to change, so it's vital to communicate all changes, no matter how big or small. While a supplier delay or small labor cost increase may seem minor, it can influence decisions made by the finance team, and knowing about major changes can determine whether you're able to collect on a change order. A lack of project knowledge could result in unnecessary payments, poor cash management or inaccurate financial reporting that will directly affect the bottom line.

Elaine Ervin
CPA, Partner
Moss Adams LLP

Q: What are the most important financial and accounting concerns for contractors who have just begun to experience a heavier workload?

Congratulations! Work has picked up, and you are growing again. Now, here are the few things you must make sure are in place so that no opportunity for growth is wasted. First, make sure that you have sufficient labor capacity to successfully complete the work you've won. Second, confirm that you have sufficient financing available to fund the increased workload. And lastly, make sure that you have an adequate bonding line to cover the work. Once you've done those three things, you are good to go. I often see contractors entering into joint ventures when they, alone, cannot meet those three goals. This can be a good strategy as long as you know that together you do satisfy all three.

Joseph Natarelli
CPA, Partner in Charge
Marcum LLP

First, while the past recession was difficult in many respects, it was valuable to help contractors truly understand what it costs to run a business. Contractors were forced to eliminate useless expenses. They were forced to do more with less. Don't lose sight of those times. As you begin to find more work, keep control of your costs and what it takes to run your business. It is easy to go back to old ways. Resist that, and set targeted gross margin and net income goals based on these new, tighter cost structures. Secondly, and not least, bigger is not better. Know what type contract you are best at, by size, geography, etc. If you are successful at $1 million contracts, you will not necessarily be 10 times better at a $10 million contract. Jobs outside your sweet spot are much more difficult to control and can quickly lead to substantial risk and losses.

Jay Rammes
CPA and Director,
Construction Practice
Barnes Dennig & Co. Ltd.

"You've made it through the Great Recession, so now that the economy is rebounding, do not chase projects that are too high risk."

Q: What is the best piece of advice you can give a contractor about obtaining adequate bonding?

Leslie Guajardo
CPA, CCIFP and Partner
Padgett, Stratemann & Co.

First, the contractor should communicate fully with the bonding agent and surety underwriter and develop a strong relationship with both. The more these advisors know, the more they will be willing to do for the contractor. As part of this flow of information, contractors should keep their bonding agents informed of upcoming projects they want to bid on and current projects in progress. Good contractors meet with their agent and underwriter at least quarterly and take them to see projects in progress and possible future projects. Second, contractors should make their balance sheet look as positive as possible. This can be accomplished by conserving as much cash as possible, having an adequate line of credit, disposing of any idle equipment and overbilling when possible to make sure certain receivables are kept current. Strong working capital (current assets less current liabilities) and healthy equity will go a long way in helping a contractor obtain the bonding capacity that is necessary.

Q: What surety predictions do you have for the remainder of 2013?

Mike Murphy
Executive Vice President and
Construction Practice Leader
HUB Northwest

Overall surety industry results for 2012 remained quite profitable, and available industry capacity remains robust. While claim frequency has increased for the larger national sureties, severity has not yet impaired their results. Thus, most healthy contractors in the $50 million-plus revenue range should continue to see very reasonable underwriting criteria applied to their businesses by their surety partners. In fact, competition is fierce for larger contractors with ample capacity, highly competitive rate options and the opportunity to reduce or eliminate personal indemnity very much on the table. For smaller contractors, particularly subcontractors and specialty contractors with regional sureties, be very cognizant of your surety's recent results, as losses incurred by certain markets or on certain classes of business could lead to tightening capacity and underwriting requirements.

Q: Do you foresee any changes in the surety industry that will impact contractors?

Tim Mikolajewski
President, Liberty Mutual Surety

Chair, The Surety & Fidelity
Association of America's
Board of Directors

The surety industry is not changing significantly but rather continues to see an evolution in the underwriting and risk-evaluation process. As contractors have grown more sophisticated over the past 20 years, so has the surety industry. The result is an industry that has stable and consistent capacity for contractors at the emerging, small, middle and large market levels. Responsible underwriting, together with deeper relationships with contractors, agents and brokers, has mitigated bonded defaults and surety losses despite the prolonged construction recession. Contractors with sound business plans and execution, who communicate regularly and openly with their agents, brokers and surety underwriters, should find good responsive capacity necessary to bid and obtain bonded work both currently and over time.

Continued on page 26

Continued from page 23

Q: What are the most important steps contractors can take to protect their balance sheets?

Larry May
CPA, CVA and
Construction Partner
Carr, Riggs & Ingram

Three things that often cause problems for contractors include adversity to debt, short-sighted tax savings decisions and owner non-income-producing projects that deplete cash and working capital. Since working capital (current assets less current liabilities) is utilized by most surety companies to compute a construction company's bonding capacity, as do many states' licensing boards, it is important to maximize this number.

Most contractors view debt negatively. Therefore, many contractors often pay cash for equipment and trucks or pay extra payments on debt to pay off sooner than required. The problem with this strategy is that equipment is a long-term asset—not a part of working capital, which uses current assets. Meanwhile, the majority of debt is usually a long-term liability and not a part of current liabilities. The bottom line is that if equipment and trucks are financed in a long-term position, then they are better paid on schedule instead of early.

Some contractors had almost rather lose money than pay taxes and therefore make short-sighted tax decisions that can significantly harm a company's balance sheet. Spending money simply to lower taxes is often not only unwise, but it also depletes working capital, which jeopardizes the future of the business. For this reason, always consult with your construction CPA before making decisions that will affect the balance sheet of the company at year-end.

Michael J. Mitchell
CPA, CPCU Vice Chairman
The Graham Company

The most important step a contractor can take to safeguard his balance sheet is having the proper terms and conditions within their insurance policies. An uninsured claim, depending on the size, can be catastrophic to a contractor. Therefore, consider working with an experienced broker to conduct a risk analysis to be sure that your policies are structured to cover every exposure, every risk. If there are coverage gaps, address them now.

Secondly, evaluate how you can better avoid or spread the risk on any given project. You've made it through the Great Recession, so now that the economy is rebounding, do not chase projects that are too high risk. Projects that are large, complicated, have onerous contract language and liquidated damages should not be chased unless the contractor has identified a way to limit or spread the project's risk. If you're working outside your geography or expertise, consider a joint venture partner or subcontract certain aspects of the job as a way to insulate your balance sheet from some of the project's risk.

Q: How will FASB's new revenue recognition standards impact contractors?

Mike Trammell
Partner & Leader,
Construction Services Group
Dixon Hughes Goodman LLP

Expect construction accounting and job costing software to undergo significant changes. Not all the construction software on the market will adapt in the same way. The industry leaders will direct resources into development and create interfaces that should make these changes less painful.

Instead of inputting one estimated gross profit or estimated total cost, interfaces will have to receive, and construction accountants will have to input and extract from estimators, more detailed information when setting up project estimates and contract schedules. Profit recognition points will have to be identified based on risk and milestone achievement. New terminology like "performance obligations" and "transaction price allocations" will become a part of the construction accounting vernacular.

There could be a shakeout in the software providers, in that some will choose not to make the necessary investment and will leave the market. The current implementation date for non-public companies is set for reporting periods beginning after December 15, 2017. While that may seem like almost five years out, the time to start evaluating whether your accounting and job costing software will assist or resist in this change is now.

Q: What recent or impending legislative changes will impact contractors?

A recent piece of legislation that will impact many contractors in the coming year is the Patient Protection and Affordable Care Act (PPACA or "the Act"). Effective January 1, 2014, the PPACA requires employers with more than 50 full-time employees, or a combination of full-time employees and full-time employee equivalents, to provide minimum essential health coverage to all of their full-time employees or potentially pay certain penalties, commonly referred to as the "play or pay" provision. In order to avoid all potential for penalty, an employer must not only offer health insurance coverage to all of its full-time employees, but that coverage must also meet the Act's defined minimum essential coverage and affordability standards. To achieve the most advantageous cost savings by the effective January 1, 2014, date, companies need to begin the process of estimating the financial impact of play or pay.

Matt Griffith
Senior Tax Manager
Sellers Richardson Holman & West, LLP

Q: How will the American Taxpayer Relief Act impact construction business owners?

Owners will certainly be affected by several key changes for individuals that begin in 2013. These include adding a new top income tax rate of 39.6 percent (up from 35 percent) for taxable income above certain thresholds. In addition, the top rate for long-term capital gains and qualified dividends increases to 20 percent (up from 15 percent), and new limitations become effective on itemized deductions and personal exemptions. The lifetime exemption for estate and gifting purposes was set at \$5 million (to be indexed for inflation) with the top estate and gift tax rate increasing from 35 percent to 40 percent. For businesses, the Act extended Code Section 179 expensing limitations (\$500,000 with a \$2 million investment limit) and 50-percent bonus depreciation for new property placed in service during 2013. Both of these provisions provide immediate tax benefits for the purchase of equipment, vehicles and other capital expenditures. These provisions are scheduled to expire on December 31, 2013, and could provide incentives for contractors to do their purchasing in 2013.

Frank Hogg
CPA, Partner-in-Charge
RubinBrown's Contractors Services Group

Q: What is the best piece of advice you can give a contractor about surviving an IRS audit?

There have been several recent Tax Court matters that have made it clear that the construction industry is being targeted by the IRS for audits. The use of independent contractors, a common practice in the industry, is seen by the Obama Administration as a way of avoiding provisions in the Affordable Care Act of 2010. Review all of your independent contractor agreements, and make sure that all of your 1099 forms are properly filed. That way, you will be in a better position if the IRS contacts you. CBO

L. Michael Gracik
CPA, Partner and Chair,
Real Estate & Construction Industry Group
Keiter, P.C.