Lang Allan & Company CPAs PC

Profitability in 2018 and Beyond

Sound accounting leads to a more profitable construction company.

Running your construction company without complete and efficient accounting systems is similar to building a house without knowing the building codes.

The self-made "home builder" may think he (she) can simply buy the hammer and materials; then, start to swing away. Eventually that strategy catches up to him/her, costing more to rebuild the home of his/her dreams the correct way.

A little planning or maybe another review of your planning strategy could pay huge dividends in the long run.

Even if you use a CPA to assist you in your tax compliance or financial reporting, here are several ways for you to improve and review your construction business.

What's in this e-book?

- Internal Controls Best Practices for Construction Companies
- Functions You Need in Construction Accounting Software
- Construction Jobs-In-Progress: Accounting Tips
- IRS Approves Section 199 Deduction for Construction Business
- The Ultimate Cheat Sheet for Construction Equipment Financing
- Avoid Buyer's Remorse, Know the True Cost of Equipment
- How to Address Potential Construction Project Delays
- Construction 2018 Forecast – Opportunities and Challenges

Internal Controls Best Practices for Construction Companies

Construction companies are at greater risk to fraud than many other businesses. The "out of sight out of mind" mentality on a job site implicitly exists. Using due diligence and proper internal controls may help mitigate some of your risk.

You can reduce fraud with the use of strong internal controls, as well as effective on-site activities. A simple surprise visit on payroll day can be an eye opener and sends a message that you are watching.

Internal Control Checklist
Below are summarized internal control procedures and best practices for construction companies.

Cash
- Proper invoice approval
- Dual signatures on checks
- Few, authorized personnel may sign checks

Subcontractor and Supplier Controls
- Compare payments to contracted amounts
- Compare original contract costs to revised contract costs on a monthly basis

Jobsite Controls
- Install and use security cameras or methods
- Compare purchased materials to original estimates
- Change order review and policies

Payroll
- Leverage sign-in/out systems to monitor daily labor requirements/activity
- Use direct deposit

Still concerned?
The Association of Certified Fraud Examiners (ACFE) created a fraud prevention checklist. Download it today to see how well you're doing to mitigate fraud in your business.[1]

[1] http://www.acfe.com/fraud-prevention-checkup.aspx

Functions You Need in Construction Accounting Software

As construction companies evolve, they quickly outgrow their first-generation accounting software packages or are not aware of the capabilities of their software.

The software was likely purchased when there wasn't a lot of capital on hand and not a lot of business to keep track of. If your company needs to upgrade, making the decision can be daunting. Here are some considerations that can help you determine if you really need to change or if your current software still has some life left in it.

Progress Billings and Retainages: Construction bills are generated sometimes for what seems like an arbitrary amount that goes against a larger contract value. Your accounting software needs to store the total contract value somewhere, and allow you to bill against it.

Retainage sometimes is withheld from billings as a job progresses. Using off-the-shelf software will require your bookkeepers to manually deduct the retainage and keep track of it. Good construction-specific accounting software will always:

- Let you put in the full invoice amount;
- Make an automatic accrual for the retainage;
- Deduct it from the invoice; and
- Put it in a separate, un-billed revenue account for tracking, collection, and proper financial reporting.

Cost Estimates and Contract Values: Some off-the-shelf software tries to lump your company's project cost estimates with your total contract values, and convince you they are one and the same thing. However, the very nature of construction accounting is costs are accrued separately and compared with contract values along the duration of each project to determine interim profits.

Your software should let you enter an estimate for the total contract cost, that can be revised, and let you enter a separate total contract amount, which is what your company will earn by doing the work. Project costs should be able to be tracked as a percentage of the total project cost easily. And it should be available in one easy-to-find report. If it is difficult to get a percentage of completion in your software by comparing each project's total cost-to-date with the estimated total project cost, avoid that software.

Change Order Income and Change Order Costs: Almost all construction companies can benefit by distinguishing between change orders on the income side with customers and change orders your company grants to those who are doing some work on your project. Even if there is no formal written subcontract with your vendors, and you are not calling them subcontractors, your company should still keep committed costs accurate, well-managed, and as complete as possible.

Additionally, as your company's income can jump significantly with one approved change order, it is critical the software allow you to easily track multiple change orders individually so they don't get confused. When evaluating software, be sure the reporting you get clearly identifies change orders and allows your bookkeepers to drill down to see all the individual approved and pending change orders.

Over-Billings and Under-Billings: Sometimes called Work In Progress, over- and under-billings must usually be shown on your financial statements and your tax returns in order for your company to stay in compliance with industry standards and tax laws. Although a savvy controller can make these journal entries so the books meet requirements for the year-end review, good construction accounting software should calculate the over- and under-billings automatically and list them as assets or liabilities on interim financial statements.

AIA Billing Documents: The AIA billing document is so common you should insist any construction accounting software package you are using print the form on-demand right from the forms or reports menu, filling in the blanks with your project financial and accounting data without any extra effort. The big names in construction accounting software all will generate AIA billing forms on-demand, saving a lot of time.

Indirect Cost Categories: All construction companies, to some degree, have a pool of indirect costs they may not be job costing. These are costs that you incur to complete your construction, yet you may not account for each dollar to a specific job per dollar incurred. Costs include contract supervision, tools and equipment, insurance, repairs and maintenance, and depreciation of owned equipment. Management should perform an analysis of their indirect cost ratio to (i) estimated on uncompleted projects and (ii) update their systems to account for these costs at least annually or when significant changes to their operations exist.

If an accounting software you are considering cannot perform these functions, your bookkeepers or worse you, will have to, creating a lot of unnecessary work.

© 2017 Thomson Reuters. Reprinted with permissions.

Construction Jobs-In-Progress: Accounting Tips

What is construction jobs-in-progress and how do I account for it in my accounting records?

All long-term construction contracts currently recognize revenue under the percentage of completion ("POC") or completed contract methods in the U.S. The POC method focuses on the company's ability to estimate its estimated cost to complete the project (or profit center) at any given time and when a company or project cannot reasonably estimate its costs to complete, it relies on the completed cost method. For small contactors, your largest creditor (i.e. your surety) will most likely require your financial statements be maintained under the POC method of accounting. For most construction companies, completing a jobs-in-progress schedule accurately is a timely task without proper training and understanding of what goes into it. U.S. Generally Accepted Accounting Principles ("US GAAP") states the POC method is the preferred method of accounting when an option exists.

Accounting Tips

1. Begin a separate job folder for each new contract. A job folder may be virtual or a physical folder. Make your job folders organized, in the same format from one job to another and a company policy to adhere to. Document important dates and summarize the scope of the work and penalty clauses up front.
2. Gather management's estimate of direct costs and indirect costs on its original bid and any subsequent change orders.
3. Job cost actual costs into your day-to-day accounting system, as noted in #1.
4. Estimate the company's indirect costs to be charged to the job, based on some constant / driver. (i.e., per hour of labor, or percent of subcontract costs) as a function of your original bid and change orders.
5. Appropriately identify your costs per a schedule of values and make sure your "up front" costs are included in an early phase of the project, so you can bill for those services timely and upfront. Spreading your costs over the life of a project delays billing, profits, and cash flow.
6. Progress bill according to the terms of your contract and strictly adhere to timely billing policies, including any retention receivable. Any disputed items from a customer should quickly be addressed and cleared up.
7. Appropriately adjust your accounting records to reflect the asset "costs and estimated earnings in excess of billings" and offsetting liability "billings in excess of cost and estimated earnings."
8. Completing a timely jobs-in-progress report will allow the company to foresee problems in a particular job as it will allow management to review a job on "costs" vs. the project manager's "gut" for its progress.
9. Address problems with a job earlier to salvage the project and minimize any risks that could occur.

As an accounting firm specializing in the construction industry, we can help to alleviate the challenge of completing a jobs schedule and spotting trends or potential problems before it is too late.

IRS Approves Section 199 Deduction for Construction Business

The Section 199 deduction for producing domestic products is often associated with the manufacturing industry. In fact, it is sometimes called the “manufacturer’s deduction.”

But, it doesn’t belong exclusively to manufacturers. Other industries, including **construction**, may take advantage of it. To drive home this point, the IRS recently issued a Technical Advice Memorandum (TAM 201638022)[1] approving the tax break for a company primarily engaged in renovation and construction.

Background Information

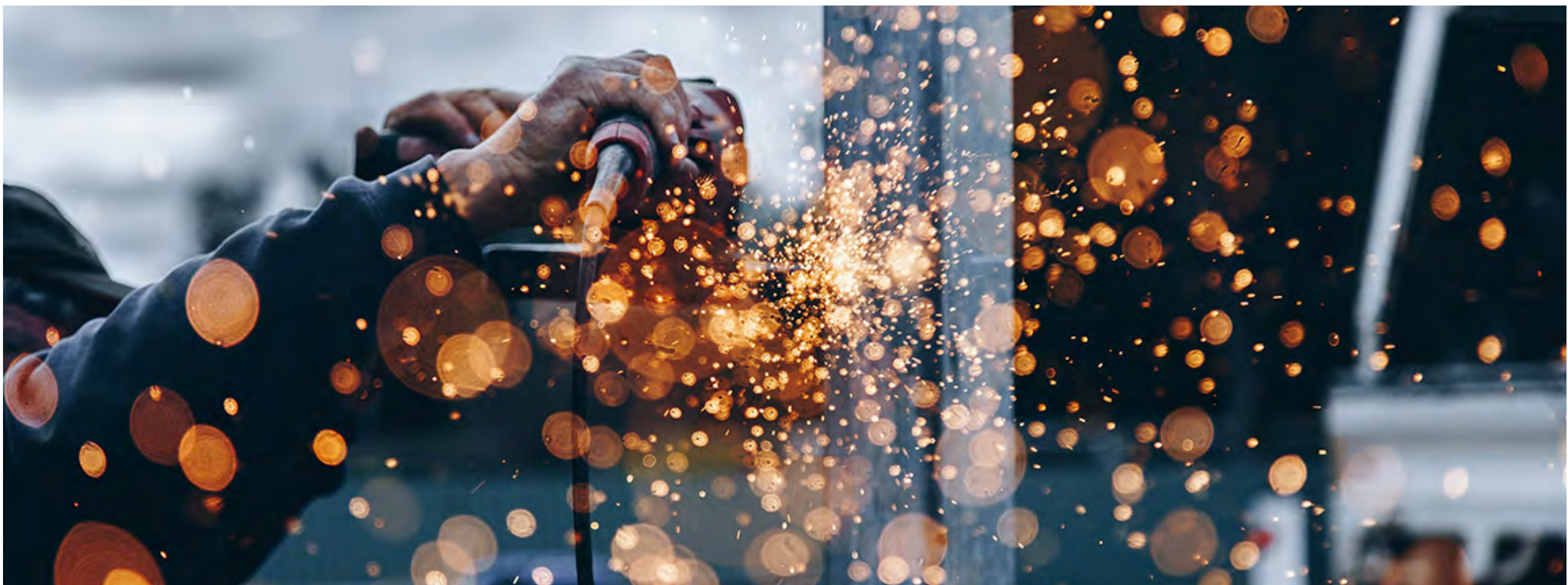
The Section 199 deduction has been around for more than a decade. When it first took effect in 2005, it was equal to 3 percent of income from qualified production activities income (QPAI).[2] It was doubled to 6 percent for 2007 through 2009, and raised to its current 9 percent level in 2010. For a business in the 35 percent tax bracket in 2017, that deduction effectively will amount to a tax cut of more than 3 percent.

The rules for computing QPAI are complex but, generally, it equals domestic production gross receipts (“DPGR”) minus the sum of:

1. The costs of goods sold that are allocable[3] to domestic production gross receipts;
2. Deductions, expenses or losses that are directly allocable to those gross receipts; and
3. Certain other deductions, expenses and losses that aren’t directly allocable to those receipts or another class of income.

For this purpose, DPGR includes money derived from the sale, exchange, lease, rental, licensing, or other disposition of certain qualifying property that must be manufactured, produced, grown or extracted (MPGE) in whole or in significant part within the U.S.

1 https://www.irs.gov/pub/irs-wd/201638022.pdf
2 https://www.irs.gov/instructions/i8903/ch01.html
3 https://www.merriam-webster.com/dictionary/allocable



Rules of the Road
Under Section 199, DPGR may be derived from the following activities:

- Manufacture, production, growth or extraction by the taxpayer of tangible personal property — including all tangible personal property (except land and building), computer software and sound recordings;
- Production of qualified film;
- Production of electricity, natural gas or water;
- Constructing real property; and
- Providing services of architecture/engineering.

DPGR resulting from the property produced must be owned by the taxpayer claiming the deduction.

Bottom Line
Keep in mind that TAMs represent a final determination of an IRS position, but only regarding the specific issue in the case at hand.

Contractors can, however, take away this pearl: Any company may be eligible for the Section 199 deduction if it meets the requirements.

As an accounting firm specializing in the construction industry, we can help identify projects, costs and potential deductions attributable to DPGR to maximize the potential deductions.

The Ultimate Cheat Sheet for Construction Equipment Financing

Every construction company owner gets to a point when he/she has to decide about new equipment. There's a lot that goes into the decision. However, some wish they had a cheat sheet to help them through the process, and here it is.

When considering the purchase, there are several financial plans, which are shared below. However, the biggest decision to make is whether to lease or buy the equipment. Both have their pros and cons. Each may be dependent upon where your business is in its life cycle. Companies in their infant stages may decide to lease to gain assets and to reduce overhead. More mature companies may choose the same option for a different reason—to be able to get rid of the equipment when the owner decides to exit the business. Companies with an established history, and that plan to stay in the industry, may choose to buy.

To Buy or To Lease

Heavy equipment purchases come with a hefty price tag and can put a real strain on your business' working capital. However, there are options that can infuse a lifeline into new businesses and can help those struggling due to the lack of heavy equipment options.

Leasing heavy equipment is similar to leasing a car. The business makes up-front payments to the lender, basically a loan, and in turn "rents" the equipment for a flat, monthly fee. When the lease period is fulfilled, the owner generally has the option to buy the equipment for its fair market value, continue leasing, lease new equipment, or return it.

Buying heavy equipment is also like buying a car. The depreciation impact is immediate. The owner has the full burden of the acquisition, meaning the owner is responsible for the equipment's resale. The asset may not be worth much when the owner goes to sell it.

Leasing
If you are considering this route, be sure to work with leasing company or financing sources who have been in business for at least as long as your new lease would last. Also, be choosy when it comes to casualty insurance and terms. Your goal is to ensure your purchase is covered in case of damage, for repairs, or when needed to pay personal property tax.

Operating Lease: This is a rental agreement with the option to return the equipment at the end of the lease term or to extend the lease. It is “rented” for a set period of time with an expiration date in the future.

Pros
- Frees up a business line of credit.
- Upgrades in the future may be done more easily.
- Deductions as a business expense apply.
- Works well when you’re short on working capital.

Cons
- Upfront costs for new or start-up companies may need personal funding via line of credit or investment.
- Higher price paid over the long term.
- Commitment to the equipment for a long period of time.

Buying
When you commit to buying equipment, it should be reflected in your business model about how you will manage that equipment and its resale period. This helps you to budget maintenance costs, depreciation, taxes, and to watch for the best market in which to sell the equipment for profit.

Pros
- You own the equipment and you control what to do with it in the future.
- If you do not have outstanding debt or have a strong balance sheet, purchase approvals may be swift.

<u>Cons</u>

- Depletes working capital/increased down payment generally required.
- May put a strain on the business.
- May require another large investment to upgrade the equipment.

Financing Options

Using all your business cash to buy heavy equipment may not be a smart business move.

- Installment or Secured Business Loan: This option allows for interest-expense deductions and depreciation. You may also trade-in current equipment or provide a low down payment with structured payments over time.
- Capital Lease: In this financial arrangement, the lessee has an ownership interest in the equipment, which means you report the lease as an asset and a corresponding liability.
- Fair-Market Value: This is a good option if you're concerned about the value of the equipment when the financing is complete or if you want to make a small security deposit with lower monthly payments. At the term end, you have three options, including extending the term, returning the equipment, or buying the equipment at its (then) fair market value.
- $1.00 Buy-Out: This option applies when you know you want to buy the equipment upon term end. You may then buy it for $1.

Taxes

Heavy equipment purchases can provide a much-needed boost to your tax deductions. However, the equipment must be in service before the end of the year for it to be claimed on your business taxes.

For assets placed in service after January 1, 2017, the maximum Section 179 deduction amount for property placed in service is $500,000, and the deduction is reduced dollar-for-dollar by the cost of qualified personal property placed in service greater than $2,000,000.

To learn more about how the costs are applied and the amount that may be deducted, read the IRS Section 179 webpage.[1]

No matter if you choose to buy or lease construction equipment, it should not tie up your company's cash flow. It should work within your business plan and help to generate or even increase revenue while you have it.

Lastly, working with experienced advisors who have assisted other construction companies with their financing and their tax deductions is recommended. There's no reason to go it alone.

1 https://www.irs.gov/publications/p946/ch02.html

Avoid Buyer's Remorse — Know the True Cost of Equipment

All construction companies store equipment, from a garage full of tools, to a scissor lift, from something as simple as an auto trailer, to something as complex as a high-tower crane.

Know the True Cost of Your Equipment

- The cost of your equipment is not just its price or the cost of fuel to operate it or the payroll of the operator on site. It also includes the associated payroll of the personnel driving the equipment, plus the additional employee costs (payroll taxes, insurance, benefits, etc.), delivery charges, setup costs and training on the equipment.
- Additional "ongoing" costs also include maintenance, storage fees, fuel, insurance, taxes and depreciation.

Know Your Hourly Cost for Equipment Use

All costs should be considered when forging your hourly cost allocations for equipment, even if these are for internal job cost accounting purposes. And whenever these costs have not taken place yet, call upon your accounting, finance or tax professional to make sure they are estimated with precision by someone with knowledge of construction industry best practices.

Many business owners consider equipment as simply a capital outlay — they just want to spend the money once and get it over with. CFOs may view a purchase as a pure balance sheet transaction — another debt payment on a financing plan.

In reality, the price of a piece of equipment has a job cost component to it as well. This is true even if the actual payments are booked to the asset or liability, and there is no general ledger expense account involved.

Bill for Your Use of Equipment, Even If You Own It

Never mistake the fact that your equipment is costing you to use it, even if you already own it. Your customers really rent the equipment from you for short periods of time on their jobs. As with a tenant, you need to set a rate for them to pay to use the equipment. The rate should not be arbitrary. In fact, you can put an "equipment rental" line item and a number of hours on your bids and invoices. Customers need not know you own the gear. Just be certain *you* know exactly what the equipment costs to run per hour, per day, or per week.

If you are not sure, consult with us for a one-time analysis. Running equipment purchases by your accountant or tax advisor beforehand to produce something like this can put you in the driver's seat, rather than looking back knowing that hindsight vision is always 20/20.

© 2017 Thomson Reuters. Reprinted with permission.

How to Address Potential Construction Project Delays

Time is money. And in the construction industry, that saying is particularly pertinent.

If a project can't be completed on time, it may result in penalties and other unwanted repercussions, not to mention the harm to a construction company's reputation. And, in the worst-case scenario, the company may not get paid at all.

Terms of the Contract. Delays in construction aren't unusual and are usually covered by the terms of the contract. Typically, contracts set a number of deadlines, with penalties for failing to complete each on time, barring any special circumstances. Of course, looming large is the ultimate deadline — the substantial completion date.

Identification of Deadlines. In some cases, the contract will specify a hard-and-fast calendar due date, such as the end of business at 5 pm (insert time zone) on December 31, (insert year). Alternatively, you might tie the completion date to a specific event, such as one year after the municipality issues a building permit or two years after the contract is signed.

Excused Delays. This is often at the crux of conflict between construction companies and clients. It's important that excused delays are ironed out in the contract. An "excused" delay is one that couldn't have been reasonably foreseen before the parties signed the contract.

Money. If delays are caused by factors outside of your control, your company may require an increase in pricing to meet the specs of the project.

Owner-Caused Delays. An owner makes substantial revisions to the building plans, fails to point out flaws in the design or other problems after work has already started or simply procrastinates when important decisions must be made. Similarly, a subcontractor may be held back by the actions, or inactions, of a general contractor.

Notification. When a delay occurs — by either party to the contract — notification is generally required. Typically, this responsibility is triggered after a designated number of days, such as 30 days after a deadline is missed. Failure to provide proper notification will often result in a waiver of rights and price adjustments.

Overview of Damages

In a typical situation, one of the parties will suffer damages when delays push back completion of the project. For example:

Damages to property owners. Due to delays, property owners may end up losing rental income, future tenants, public incentives and tax benefits, and financing opportunities, just to name several of the main possibilities. It may also require additional interest costs on loans and other related expenditures.

Damages to construction companies. A company will likely face additional overhead costs when a project drags on past the stated deadline. In addition, revenue will be lost when crews remain tied up on the job when they could be working elsewhere.

Liquidated damages. These are damages agreed upon in the contact if one party breaches the contract. For instance, liquidated damages may apply if a contractor breaches the contract by missing the substantial completion deadline.

Review Closely

- Pay close attention when you enter into a deal no matter how profitable it initially appears. Have your legal advisor draw up the contract to help ensure you're adequately protected in the event of any significant delays.
- If you use a date tied to an event, make sure that the language in the contract is clear.
- When possible, be specific regarding events that would result in an excused delay. For example, a strike by vendors providing raw materials might be listed as an excused delay. Conversely, inclement weather might not be allowed as an excused delay, depending on the geographic location of the project.
- Excused delays can be a significant negotiating point and your interests may lie in whether your company is the general contractor or a subcontractor. Although it may be difficult to resolve these issues at the outset, it could save plenty of hassle — not to mention legal fees — by coming to a clear agreement in the contract.

- Best to address contingencies in the contract and clearly define the terms before problems occur and rely on an exact formula for attributing costs.
- Delays may occur because the owner fails to make good on certain promises, such as payment at different stages of the project and address these situations sooner than later.
- A liquidated damage provision generally stipulates an amount (such as $1,000 for every day the project is late). The amount is usually deducted from the project price.

© 2017 Thomson Reuters. Reprinted with permission.

Construction 2018 Forecast — Opportunities and Challenges

The 2018 Construction Forecast Report[1] has been released and it is looking good for both the U.S. and Canada. It estimates that residential construction could grow by as much as 6 percent, non-residential by 2 percent, and non-building by about 4 percent.

According to the 2018 Construction Industry Economic Outlook[2], commercial construction could see an increase of as much as 12 percent. Manufacturing facilities, on the other hand, may experience a decline of about 5.5 percent, down from the 22.8 percent increase is experienced in 2017. Private residential could see an additional 6-9 percent increase over 2017, while private, non-residential could only experience a 1-5 percent increase. Residential construction, specifically single-family homes, may see an uptick if millennials decide to purchase homes. Stadium and arena construction could increase due to the proposed football stadiums in LA and Las Vegas, plus soccer stadiums in and near Miami. Lodging construction may decrease along with retail construction, which could be due to ecommerce development. Airport construction could lead the pubic construction space, with airport terminals and runway expansions.

The Dodge Data & Analytics Outlook Report[3] states that the construction industry “has moved into a mature stage of expansion.”

Opportunities

- Corporate Tax Rate Decrease. With the new Tax Reform bill passed, it reduced the corporate tax rate from 35 percent to 21 percent, with hopes to spark the manufacturing industry.
- Natural Disasters. The hurricanes and wild fires of 2017, could provide opportunities in the areas most damaged by the natural disasters.
- Tax Reform. Investments in non-residential construction could see a bump due to favorable business conditions.

1 https://www.buildingsolutions.com/2018-construction-forecast-report
2 https://www.constructconnect.com/blog/construction-news/2018-construction-industry-economic-outlook/
3 https://www.construction.com/news/new-construction-starts-2018-increase-3-percent-765-billion-dollars-nov-2017

Challenges

- The Industry Economic Outlook report also states that ongoing construction costs could also increase for 2018, around 2-3 percent, and labor costs by 3-4 percent.
- Labor Shortages. According to the report, "Construction employment is still more than 10 percent below is previous peak." Which means many firms are having a hard time filling positions for skilled trades, such as carpenters, plumbers, concrete workers, electricians, and bricklayers.
- Mortgage Interest and Property Tax Deductions. Both items were reduced in the Tax Reform Bill, that could cause the single-family residential market to take a hit.
- Commodities and Materials Pricing. Both areas are expected to increase in 2018, forcing construction firms to decide where to spend, which could impact profit margins, or simply use what they have.

Your Roadmap

With all this data, and more if you read each report, at hand, what's the roadmap look like for a construction business owner? Now is the time to prepare your 2018 – 2020 strategy to help adjust for the ebb and flow of the industry to help keep your firm in the black.

Here are some suggestions:

1. Fraud. With the potential for high employee turnover, firms should consider whistle-blowing programs and job screening more carefully.
2. Safety. With fewer employees, on-the-job work injuries and sick leave hurt even more. Additional equipment training opportunities should be figured into the plan.
3. Materials. Due to the potential increase in material costs, now is the time to review your current expenses to find opportunities to decrease costs while increasing productivity. A professional review of your firm's spending habits could provide cost savings.
4. Tax Deductions and Fleet Maintenance. Familiarity with tax laws, simple maintenance steps, and high-tech solutions can reduce the costs of operating your fleet and keep it safer. Learn more in this post.[1]

1 https://langallancpa.com/tax-deductions-and-fleet-maintenance-help-you-save-money/

5. Certify Financial Statements. If you are planning to lease or buy heavy equipment in 2018, you may need a loan. If so, having certified financial statements will smooth the process and potential for securing that loan. Learn more about Certified Financial Statements in this post.[1]
6. Accounting Software. As construction firms evolve, they quickly outgrow their first-generation accounting software packages. Now is a good time to review what's working and what's not working in your accounting tools. In this post, we outline some tips.[2]
7. Project Delays. Pay close attention when you enter into a deal no matter how profitable it initially appears. Have your legal advisor draw up the contract to help ensure you're adequately protected in the event of any significant delays. We have several other tips to help overcome project delays[3] in this post.

The new year might be a great one for your firm. However, without the proper road map, you may find yourself stuck in rut.

Give us a call to help **Move Your Company Forward** and to give you the peace of mind you need to increase business.

1 https://langallancpa.com/eight-reasons-to-certify-your-companys-financial-statements/
2 https://langallancpa.com/functions-you-need-in-construction-accounting-software/
3 https://langallancpa.com/how-to-address-potential-construction-project-delays/

Congratulations!
Now you have the basic steps to ***Move Your Company Forward.***

Do you need a partner to *Move Your Company Forward?*

Call us at 303-792-9445.

About Lang Allan & Company CPAs PC

Lang Allan & Company CPAs PC provides audit, review and compilation attest services, tax financial accounting and management and consulting services to small and mid-size construction companies. Our goal is to serve your needs in a professional, prompt, and courteous manner.

We believe it is important for you to know we care about you and your future. We will always provide personalized services to businesses and their owners.

At Lang Allan & Company CPAs PC we have an expertise in serving the construction industry throughout the United States. Through our experiences and understanding of the industry and communications with sureties and bankers, we gain a further understanding of the issues relevant to the construction industry. As a client, you will be able to leverage our relationships with other professionals and gain an increased credibility with financial institutions and bonding companies.

Our big firm experiences, combined with small firm service helps to ***Move Your Company Forward***.

Location
6130 Greenwood Plaza Blvd, Ste 130
Greenwood Village, Co 80111
303-792-9445

Contact
Adam Allan, CPA
Shareholder
info@langallancpa.com