

ON-SITE

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Accountants and Business Advisors

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Don't let the numbers beat you

Re-evaluating your accounting methods

In the construction business, plenty of things can beat you. One is numbers — that is, if you don't stay on top of how you account for your income, you could end up overpaying your taxes and missing out on key strategic opportunities.

If your company's average annual gross receipts for the past three years are less than \$10 million and you have significant work in progress at year end, a number of tax accounting methods may be available.

The cash method

Generally, the most straightforward approach is the cash method, under which a taxpayer recognizes income when it's received. If your construction company qualifies under IRS standards (ask your CPA for details), you may use the cash basis accounting method and deduct the cost of materials either when you pay for them or when you sell them as part of the project, whichever is later.

If you operate as a C corporation or partnership, or a limited liability company (LLC) with a C corporation owner, and your average annual gross receipts exceed \$5 million, you can't use the cash method. And even if you aren't connected

to a corporation, you may not be able to use it if your materials purchases total more than 10% of your company's gross income for the year.

The accrual method

More common to the construction business is the accrual method, under which a taxpayer recognizes income and expenses when the underlying service or event occurs — not necessarily when cash changes hands.

You include income when it's earned, when it's due or when it's received, whichever is earlier. And you record expenses and job costs in the year in which you incur them, which is the later of when you receive the materials or services or when you can accurately determine the amounts of the expenses.

The accrual method typically provides a more accurate matching of revenue and expenses than the cash method. Moreover, the accrual method can allow additional tax planning opportunities through year end accruals.

In fact, the IRS requires most contractors to use the accrual method for their overall operations, though you'll need to consider special rules and limitations when deciding which variation of this method is best.

Contract-specific methods

You should also reassess regularly how you're accounting for your long-term contracts — those not completed in the same year started, regardless of the time you take to actually complete the job.

One option is the percentage-of-completion method. Here you report income according to the percentage of the contract



JOINT VENTURES BRING ACCOUNTING CHALLENGES

If you undertake a project as a joint venture with another company, you'll face some distinctive accounting method challenges. For instance, joint venture partners who own between 20% and 50% of the operation are said to have "significant influence" in it and, as such, they typically must use one of two approaches:

1. The equity method. Under this approach the joint venture holding is reported in a one-line entry on their balance sheets, and their interest in the joint venture profit or loss is included as one item in the statement of operations.

2. The expanded equity accounting method. Here the owners' financial statements show each joint venture asset, liability and share of revenues and expenses as a line item in the respective categories on the financial statements, but the accounting result is the same as that of the equity method.

Joint venture partners who have more than 50% control of the enterprise should use the full consolidation accounting method, under which the joint venture's financial statements are consolidated with the owners'.

If joint venture members receive pro rata shares of assets and liabilities, rather than holding specified percentages of equity, they usually need to follow the *partial* consolidation accounting method. The pro rata calculations are what differentiate these ventures from those subject to full consolidation.

For more information about the concept and control measurements for joint ventures and other related entities, ask your CPA about the Financial Accounting Standards Board's Interpretation No. 46, *Consolidation of Variable Interest Entities*, which is often referred to as FIN 46(R).

completed during the year. This percentage is calculated by comparing expenses allocated to the contract and incurred during the year with the estimated total contract costs.

The benefit of the percentage-of-completion method is a more accurate allocation of income and expenses. The IRS, however, requires you to do a separate "look-back" calculation for tax purposes that may result in interest charges.

An alternate option may be the completed-contract method, whereby, even though you may receive payments in years before completion, income isn't reported until you complete a contract. Thus, it's advantageous because you can defer taxes.

But you can't include the cost of supplies or materials you allocated to the contract but never used as an allocable contract expense. These supplies must remain on the books as an asset until they're used in a project. At that time, they may be deducted.

Whether you can use the completed-contract method for all or part of your income depends on the size of your company as measured by gross receipts and the type of construction you do. Larger construction businesses (those with three-year average gross receipts over \$10 million) must generally use the percentage-of-completion method, while smaller ones must do so only for contracts that will take longer than two years to complete.

Construction companies with gross receipts under \$10 million may use the completed-contract method for contracts they're likely to complete in less than two years.

Your method of choice

Bear in mind that the rules governing tax accounting methods are complex and we don't have space here to cover all of the exceptions and variations. Even if you're comfortable with your method(s) of choice, it doesn't hurt to re-evaluate your options regularly with your CPA. [↑](#)

Better bid better: Do's and don'ts for staying competitive

As competition across all sectors of the construction industry heats up, any competitive disadvantage can become magnified tenfold. One specific area of concern: bidding.

If you're not performing at the highest possible level in this area, you had better bid better. Here are some do's and don'ts for staying competitive:

Do consider today's estimating software.

Where do bids begin? With estimates. And how can you improve your estimates? By looking into new technology.

Today's estimating software now offers 3-D capabilities that allow estimators to see their work from all angles and in vastly more detail than previous software. For instance, an estimator can separate construction components from the overall structure to scrutinize them individually.

Of course, these applications come with substantial purchase and implementation costs. And you'll likely need to provide training on the software for your estimators. But the benefits are there for the taking.

Don't focus solely on direct costs. Like most contractors, you're probably pretty good at identifying direct costs. Yet one problem that scuttles many bids is focusing solely on these amounts and ignoring or miscalculating the indirect costs that might affect the job.

One example is the equipment you own. If you have fully paid off a piece of equipment, you may not see any current cash outflows associated with it. But if you're not allocating an expense for the equipment, you may not be recovering costs on depreciation, repairs, property taxes, storage and insurance. You need to include all of these costs in a bid.

Do check your math when it comes to profit margins. Calculating profit margin is always

tricky. Once the numbers start flying, it's important to keep your head and not end up undercutting your own profitability.

Assume you'd like to bid a \$600,000 sales price for a job with costs of \$500,000 — that is, you want a 20% markup. To figure the margin, you'd need to subtract the cost from the sales price: $\$600,000 - \$500,000 = \$100,000$ gross profit. But $\$100,000 / \$600,000$ is only 16.7%, not 20%. What's wrong with this picture?

If your goal is a 20% margin, you'll need to sell your job for \$625,000 in order to reach it. The calculation would be $\$625,000 - \$500,000 = \$125,000$ projected margin. Then: $\$125,000 / \$625,000 = 20\%$ margin.

One problem that scuttles many bids is focusing solely on direct costs and ignoring or miscalculating the indirect costs that might affect the job.

Don't underestimate the competition. When working on a bid, it's easy to be self-focused. After all, you're assessing *your* company's capabilities in light of the demands of a project to determine how much you should charge.

But the nature of the competition can seriously affect your bid. If two of your main competitors are notorious for bidding low, you may have to reduce your bid comparatively. Is the job still worth it? This is another good reason to be aware of who's working in the same markets as you are.

Competition is tough, so it pays to be proactive: Fine tune your bids and evolve with the times. *T*

Why bother with a business valuation?

3 reasons to bump one to the top of your to-do list

In the course of any given day, contractors have plenty to worry about. After all, you have to not only do a good job, but also find, bid on and win enough jobs to make a living.

So if you get a call from your CPA recommending that you engage a qualified appraiser to estimate the value of your construction company, you might respond, “Why bother? There’s no better way to increase my company’s value than to keep working!”

Fair enough, but there are three excellent reasons to bump a valuation to the top of your to-do list.

1. Changing your ownership status

If you intend to sell or transfer ownership of your construction business in the future, a professional business valuation is essential. Not getting a valuation when selling your business is akin to not learning your car’s Blue Book® value before selling it.

Even if you want to sell only part of your company, perhaps to a partner, employee or employee stock ownership plan, you need to know the value of the interest you’re transferring. Or perhaps a larger company is trying to woo you into a merger or acquisition. Don’t consider the deal unless you know your company’s relative fair market value for financing or exchanging stock.

2. Obtaining financial support

Cash flow is critical to the success of any construction company. And to keep those dollars moving to where you need them, you may need to turn to outside financial support.

When dealing with your bank, knowing your company’s value may lend a little more weight to your side of the bargaining table. For example, do you own any paid-off or fully depreciated heavy equipment that still retains substantial value?



If so, valuing this equipment can enable you to refinance it or secure new debt.

Or you may need to value your business as a whole to obtain financing when securing debt with company stock. Doing so can help you grow faster and expand further than via traditional financing methods.

3. Creating or updating an estate plan

A construction company’s value affects the tax-related costs of selling, gifting or bequeathing its business interests. Failing to estimate value properly may leave your heirs on the hook for a sizable estate tax bill that could force them to sell your company after your death.

Arriving at an acceptable value estimate is no easy task. According to the IRS, no fewer than *eight* factors must be considered when valuing shares in private companies for estate and gift tax purposes.

Other significant life changes also may require knowing the value of your company. For instance, if you divorce, a property settlement would no doubt call for a valuation. And if your long-term goal is to retire comfortably by converting the proceeds from the sale of your construction business into a viable retirement asset, periodically assessing its value is a must.

Protecting your intellectual property

Intellectual property (trade secrets, patents, databases and so forth) is becoming increasingly important to contractors. Many construction companies now post proprietary home plans on their Web sites or maintain blueprint databases, making it all too easy for others to infringe on that property.

Should a case involving intellectual property go to court, it's critical that you be able to authoritatively assert the value of that property. Professional appraisers employ a variety of methods to value intellectual property, most of which are far too complex to go into here.

Good business

These are just a few of the reasons to obtain a valuation for your construction business. Simply put, it's just good business to know the value of your company. [7](#)

Futurescope: Construction Business Trends *More contractors turn to document retention policies*

When many people think of the construction business, they envision hardhats and cement trucks. But contractors know that a big part of their operations doesn't involve building materials but rather *paper* materials — contracts, tax forms, bank statements and so forth.

Some construction company owners squirrel away these documents permanently until their file cabinets are creaking under the weight. Others keep only the documents they need and shred the rest or, worse, simply toss them in the circular file.

The ideal way to manage your construction company's paperwork, of course, lies somewhere in between. And to attain this ideal, many contractors are creating formal document retention policies.

A good way to begin creating your policy is to find someone to champion it. This person might be you, a manager or even an administrative staff member. In any case, your "document archivist" must have the skills to devise an exhaustive index of your company's critical documents and then work with you to determine the retention periods for each. Here are some general guidelines:

Tax and insurance records. Keep your tax returns permanently to prove that you filed, and keep the supporting documentation for seven years. Payroll tax returns, however, generally need to be kept for only four years. Hold on to insurance policies indefinitely because the burden is on you to produce this document if a coverage issue arises.

Project records. Retain as-built drawings/specifications for 10 years after completing a project. Keep warranty papers on any vehicles or heavy equipment for the life of the warranty. File contracts for 15 years following completion.

Employment records. Keep employee records on file throughout an employee's tenure, plus the statute of limitations period after termination, which varies by state. Maintain training manuals and union agreements permanently.

At first glance, the cost (in both dollars and time) of creating and implementing a document retention policy may seem prohibitive. But, without an enforced policy, you could very well lose or mistakenly destroy documents and, in turn, suffer substantial expense re-creating them or, even worse, find yourself helpless in a litigious situation.

The Contractor's Corner

RFID lets contractors “play tag” with their materials

As a general contractor, I work with construction materials — and their high costs — every day. As the price of all of these “nuts and bolts” continues to soar, the cost of losing them has become increasingly high as well. And it’s something that’s been happening all too often. Is there a better way to track my materials?

You may want to consider radio frequency identification (RFID). This technology lets contractors “play tag” with their materials — with some potentially considerable benefits.

What’s the big idea?

The big idea behind RFID is to transmit information about an item or object wirelessly. A “tag” — or microchip with an antenna — is placed on an item, and a unit called a “reader” then interprets and conveys the data from the microchip using radio waves.

Now that may sound like bar coding, but RFID doesn’t require you to manually scan a label. In fact, the readers can usually pick up information from many feet away. RFID can also track multiple objects in real time — with or without the assistance of a human attendant.

For contractors, RFID’s usefulness is fairly obvious: It can let you read and track materials from truck to storage to installation via a global positioning system. Thus, you’re able to better monitor and control the flow of materials, reducing downtime and streamlining project schedules.

For instance, just this year, a crane leasing company has been using RFID to track and locate its crane parts. An assembled crane can cost as much as \$700,000, with the individual parts running around \$17,000, so the expense of losing even one component could hurt the company’s bottom line considerably.

What are the risks?

Naturally, RFID isn’t without its risks. First, you may find the upfront expense of a system prohibitive. Remember, you have to not only buy the system, but also install it and teach your entire staff how to use it. Plus, those tags don’t last forever — many last only five to six years — so you’ll have to replace them eventually.

In addition, as with any radio signal, RFID systems may suffer from interference. The most common causes are metal objects blocking the transmission path and multiple tags coexisting on the same frequency band.

Last, though RFID tags are tiny — both physically and in terms of memory (most hold less than a kilobyte of data) — they can become infected with the same types of viruses and worms that attack conventional computers. For example, RFID software coding errors can leave your computer programs open to the planting and execution of malicious code.

There are ways to combat this threat, such as housing your RFID “middleware” on a separate server and segregating system users into different groups based on access requirements. But it’s a chilling reminder of just how pervasive data security threats are.

Are you ready?

Whether your construction company is ready for RFID depends on a number of factors. Can you afford it? Do you and your staff typically pick up on new technologies quickly? Do you even need it? Maybe your current materials tracking system is just fine.

Nevertheless, it’s worth considering. RFID’s speed and practicality are making waves in many industries — including construction. **T**



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A 17-year veteran of Elliott Davis, Jeff provides a wide range of business and financial consulting services to large and middle market construction companies, architectural and engineering firms and general/specialty contractors. As the former CFO of a large, closely held general contractor, Jeff brings to clients valuable insight and a unique perspective based on his in-depth knowledge and first-hand industry experience. His specialized expertise includes: assistance with bankers, bonding agents, sureties; business insurance analysis and review; incentive compensation plans; cost segregation studies; management succession planning and multistate incorporation and licensing.



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Travis specializes in the preparation of income tax returns for corporate entities, partnerships and individuals. Travis also provides tax planning services for businesses and individuals. He consults with clients in a variety of areas, including succession planning, cost segregation studies and incentive compensation plans.



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During his 11-plus years with Elliott Davis, Todd has provided comprehensive assurance and advisory services to a diverse client base which includes construction companies, institutions of higher education, manufacturing, wholesale companies, not-for-profit entities, service organizations, car dealerships and governmental entities.



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Jim has more than seven years experience in public accounting providing advisory and tax services to clients primarily in the construction industry. His experience in providing extensive services to contractors in the industry includes: general, electrical, mechanical, heavy highway, grading, homebuilding, and other niche contractors.

Elliott Davis Services

In addition to offering personal and varied services to clients in a number of specialized industries, such as construction, Elliott Davis also provides deep collective experience in accounting and advisory functions:

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- Retirement Plan Administration
- Business Strategy
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- Technology Solutions
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