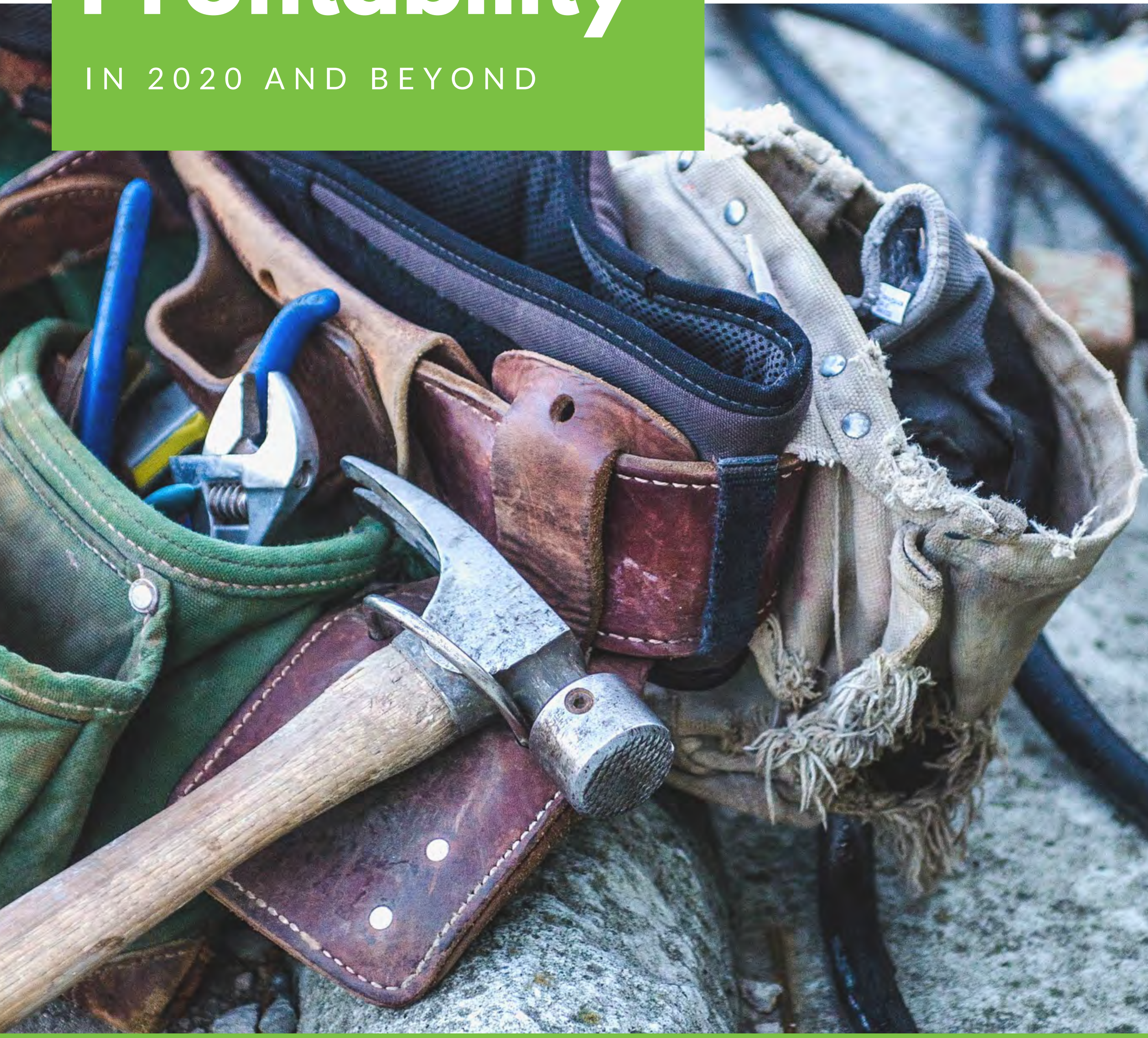
# Profitability

IN 2020 AND BEYOND



ESSENTIAL TIPS FOR MANAGING YOUR CONSTRUCTION COMPANY'S INVENTORY

INTERNAL CONTROLS BEST PRACTICES FOR CONSTRUCTION COMPANIES

REVENUE MANAGEMENT IN CONSTRUCTION

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, materials, and start to swing away. Eventually this strategy catches up to you and it costs more to build the house of your dreams the correct way.

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

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

## Table of Contents

## Challenges to Overcome in 2020

According to Construction Analysis, with spending for construction projected at $1.426 trillion in 2020 (6.3% increase) compared to $1.341 trillion in 2019 (1.5% increase from 2018), the rising costs continue with certain sectors feeling more impact and others getting a slight reprieve.

Across construction, there are a few challenges that everyone will be facing, including:

**Labor Shortages:** Most states will not see a significant increase in employment rates, which will intern compound the challenges to find skilled labor.

**Material Costs and Resources:** With tariffs going into full effect in 2019, and impacting the cost for lumber, steel, aluminum, and more, it challenges many contractors to guarantee material costs.

**Stagnant Productivity:** According to a recent report from McKinsey & Co., "the productivity of construction remains stuck at the same level as 80 years ago. Current measurements find that there has been a consistent decline in the industry's productivity since the late 1960s." There are several factors contributing to the stagnation, such as more complex projects, inadequate planning and scheduling, lack of collaboration between stakeholders, and delays in material and supply deliveries.

**Insurance Costs and Coverages:** This must-have expense is a tough one to cut. Rather, compare pricing on policies for the best rate and coverage. Remember to look for three, hidden exclusions that can hurt your company in the long term, including defective work coverage; external insulation finishing systems, which impacts the coverage of damages or injuries on site; and employer's liability exclusion.

**Preparing for the Future**

These challenges threaten the construction landscape. Companies that address the issues with technology and procedural changes, such as supply chain strategies, mobile tech, building information monitoring, and use of robotics, will have a leg up on the competition. Those who lager will find the uphill battle even more challenging.

## Revenue Management

Many important changes in the marketplace pertain to revenue management, and these changes are affecting every industry from retail to construction. If you own a construction company, it would be prudent to spend some time better understanding the new economy to see how your business can succeed in the coming years.

Before you make your next business decision, evaluate the following important considerations:

**Are you risking noncompliance by not understanding new standards?**
Industry standards change regularly, and many are government mandated. By failing to understand these new standards, you run the risk of being noncompliant, which could become a barrier to continued success in the future, which is simply the best-case scenario.

**Did you know your data could be compromised if you use spreadsheets alone?**
For example, simple spreadsheets, like Microsoft Excel, are not considered sophisticated enough to maintain the right financial records. Yet, many construction companies admit that they are still using spreadsheets as their primary data collection tool.

**Are you familiar with ERP software and how to manage your revenue?**
Enterprise resource planning (ERP) systems can automate much of your data collection process. The many packages from which to choose, however, can make the process of transition intimidating for many construction business owners.

**Are new billing standards taxing your current systems?**
If you cannot process billing effectively or efficiently, you will interrupt your cash flow process, which may be detrimental over time. If you're finding the process to be complicated or difficult, it is time to consider a new revenue management system.


Photo: Goumbik

## Essential Tips for Managing Your Inventory

Construction and inventory don't always go hand in hand, but it's important to understand your company's cost to acquire products as your largest expense.

For construction company owners who don't utilize an effective inventory management system to track demand, sales, and delivery processes, unused materials can lock up a large portion of your cash. That portion frequently represents cash that might be better spent on other business assets.

### The Dangers of Neglecting Your Inventory

Construction companies that ignore inventory become easily susceptible to data entry errors, purchasing mistakes, and unreliable information about what they actually have on hand. With such mismanagement, you're setting yourself up for customer dissatisfaction. When it comes to construction, your inventory needs may be significantly different than your business or manufacturing counterparts, so it is important to understand how this process could work for you.

### Take Steps to Improve Your Inventory Management

Fortunately, you can take a few simple steps to ensure that you're maximizing inventory management. You can start by focusing on these four aspects:

- **Being frugal.** You not only will spend less money, but can also identify effective ways to keep your costs down.
- **Tracking costs.** Don't guess, track your costs as accurately as possible. The total cost for labor and materials necessary for the finished product is essential, so set appropriately competitive prices for your customers that can provide you with a healthy profit.
- **Manage materials.** Consider looking into tracking software that can provide an efficient inventory tracking solution appropriate for the construction industry. Many options are available, so do your research to determine the best options for your specific needs and budget.
- **Review needs.** You can monitor the types of projects you work on regularly and track the demand and product life for everything you purchase and use. This will also help you determine patterns so you aren't caught off guard when needs arise.

Committing to these practices should put you in a better position to weather lean times, as well as to take advantage of robust periods in construction. The primary goal is to leverage a clear perspective and understanding of your materials control to make informed decisions that will strengthen and increase your competitive advantage.

Photo: Ri Butov

## Internal Controls Best Practices

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.

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.


Photo: Tumisu

## Functions You Need in 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.

Photo: Shooterple

Additionally, as your company's income can jump significantly with one approved change order, it is critical that 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, depreciation of owned equipment. Management should perform an analysis of their indirect cost ratio to (a) estimated on uncompleted projects, and (b) 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. We can help to alleviate the challenge and to Move Your Company Forward.

Photo: Michael Gaida

# 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 United States. 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 ("U.S. 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.
4. Estimate 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 managers "gut" for its progress.
9. Address problems with a job earlier to salvage the project and minimize any risks that could occur.

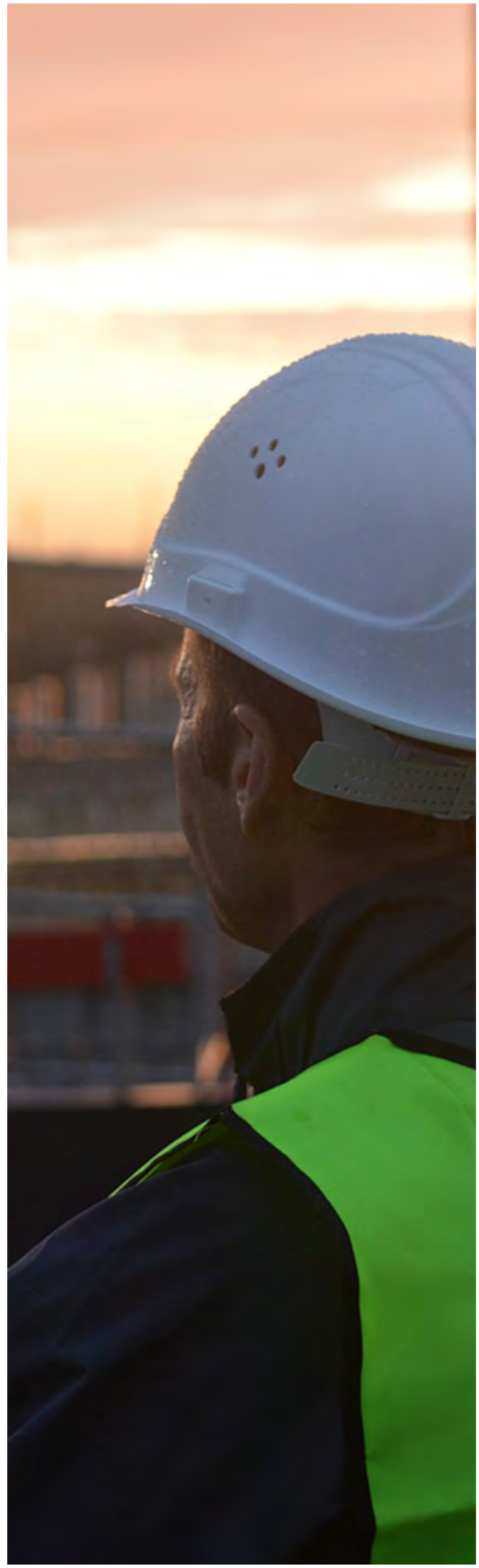


Photo: Ben Kerckx

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. We can work together to Move Your Company Forward.

Photo: Borko Manigoda

## Section 179 Deduction and the Bonus Deduction

The bonus deduction and the Section 179 deduction are tax incentives for businesses that purchase and use qualified business property. Both of these deductions apply to the same kinds of property — interior improvements (1) made to a property that is used at least 50 percent for business; (2) made after the property was put into use; and (3) that are depreciable because they have a useful life of more than one year. Both of these deductions exclude land, but they are not the same.

Business owners are allowed to claim both incentives, but the Section 179 deduction must be taken first. This can be confusing, but there are real differences between what is allowable under Section 179 and under the bonus deduction.

**Section 179 deductions allow for the following:**

- Section 179 allows businesses to expense a cost of qualified property immediately, whereas depreciation allows a business to recover that cost over time.
- Under Section 179, qualified property includes tangible personal property, computer software, and qualified improvement property.
- The Section 179 deduction, which reduced the cost of the qualified property that was purchased, is taken first. Bonus depreciation then is taken to decrease the remaining cost of the property over its useful life.
- Businesses can deduct up to $1 million of qualified property immediately, with a phase-out threshold of $2.5 million. Once a tax year exceeds the threshold amount, the Section 179 deduction is reduced dollar-for-dollar by the excess amount. Beginning with tax year 2019, the deduction and phase-out threshold amounts are subject to inflation.
- Section 179 is limited to taxpayer's business income. Passive income is not eligible for the deduction.
- Any Section 179 deduction elected that is not allowed because of the income limitation can be carried forward to future years.

**Bonus depreciations work differently:**

- Before the Tax Cuts and Jobs Act of 2017 (TCJA), bonus depreciation applied only to newly purchased property. The TCJA changed that by allowing used property acquired and put into use after September 27, 2017, and before January 1, 2023, to be depreciable if it meets certain requirements. It also increased the deduction to 100% for purchases of qualified property made between September 27, 2017, and January 1, 2023. Property that is eligible for the bonus deduction must fall under the Internal Revenue Service (IRS) definition of qualified property.
- With specific exceptions, bonus depreciation is scheduled to be reduced gradually for assets placed in service between 2023 and 2026.
- The IRS defines qualified property as property that wasn't (1) used by the taxpayer or its predecessor before it was acquired;

Photo: Erich Westendarp

(2) acquired from a related party; or (3) acquired from a component member of a controlled group of corporations.

- The taxpayer's basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer's basis of the used property is not figured under the provision for deciding the basis of property acquired from a decedent.
- The property may not have been the basis of any property previously held by the taxpayer (e.g., in a like-kind exchange or involuntary conversion).

There are other notable differences as well. For example, HVAC improvements are deductible under Section 179, but not under bonus depreciation. As a result of these differences, claiming depreciation deductions can get complicated. To maximize the benefits, business owners need to plan for purchases of qualified property. They also need to keep careful records of purchase date, date the property was put into service, and all costs associated with the purchase.


Photo: David Dunmore

# 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. 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 those are for internal job cost accounting purposes. Whenever those costs have not taken place, 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.

Photo: Jacob Totolhua

## How to Address Potential Project Delays

Time is money. And in the construction industry, this 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. 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 5:00 p.m. (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, so 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, fail to point out flaws in the design or other problems after work has already started or simply procrastinate 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.

Photo: Pexels

### 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.

Photo: Jason Pinaster

Congratulations, you made it through this ebook. 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