

# contractor

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**Smith & Gesteland<sub>LLP</sub>**

Certified Public Accountants & Business Consultants

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*Not The Same Old Bottom Line*

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## General contractor focus

# When scheduling subs, keep in mind the bottom line

If there's one thing guaranteed to erode the bottom line on a construction project, it's subcontractors who throw things off schedule. Keeping in mind the bottom line when managing your subs can put you in a better position to roll with any other punches the project throws at you. Here are some tips.

### **DON'T JUST COMMUNICATE, COLLABORATE**

As soon as you win a bid, call the subs you'll need. They know their business better than you do, so review the plans with them and ask for help identifying any potential problems.

Then work with them to develop a realistic project schedule. Remember to consider the tools, equipment and materials that each will require at each stage. It does no good to have the plumber show up on time if you don't have the pipes on site when he or she arrives.

Because neither you nor the subcontractors can predict every problem that will arise, build in a little leeway

along the way, too. Some contractors schedule only four days of every five, leaving one day open for subs to catch up if necessary.

### **PUT IT IN WRITING**

When you have a schedule that looks good, put it in writing. A good ol' Gantt chart still works, or an Excel® spreadsheet is fine. Assuming it's legible, even a large piece of paper with a hand-drawn calendar will probably suffice.

*Getting subcontractors bonded is critical in the event a sub is unable to finish his or her work.*

Whatever you use, just be sure everyone signs off on it. In doing so, they're agreeing to the schedule's terms. And having a document to prove this could help defuse any differences of opinion that develop later in the job.



## GETTING THE MOST FROM YOUR SCHEDULING SOFTWARE

A good scheduling software package can help keep construction projects on track from bid through the last item on the last punch list. Yet if you're using one of these applications as little more than an electronic calendar, you may be missing out on a lot of useful functionality. Here are some tips for getting the most from your system:

**Use templates to save time.** Most software allows you to take advantage of your experience by creating standard schedules based on tasks you know the job will include. Be sure to consider variables, though, because no two construction projects are ever exactly alike.

**Integrate your scheduling and accounting software.** As jobs proceed, you can track and update billing and expenses in concert with the schedule. By doing so, you'll be able to keep close tabs on job costs and identify resources that you could reallocate to other projects.

**For better results, drill down.** Use your software to create not only large, overview schedules, but also smaller, more detailed ones for specific tasks. This way, you can prevent anything from slipping through the cracks and cut down on unpleasant last-minute surprises.

This is also a good time to check in with your subs about bonding. For projects that are bonded, getting subcontractors bonded is critical to protect yourself in the event a sub is unable to finish his or her work.

### BE A BOTHER

Once a sub is signed on and the schedule is set, some general contractors feel they're being a bother if they follow up. Don't worry about that — being a bother can pay off later on when the project goes smoothly.

Remind your subcontractors of the schedule they signed off on and, specifically, of their individual timetables. As work progresses, keep subs informed. Let them know if you hit a snag that could cause a delay. Give them the chance to fill those days with other jobs, if possible. And even if there are no delays, update subs on how the job is progressing.

When the time is drawing near for a particular subcontractor to begin work, call or send an e-mail — with a reply requested — to be sure everything is still going according to plan. Some contractors make that contact two weeks in advance; others may feel safer doing it up to a month ahead.

### INVOLVE OTHER PARTIES

Other things you can do to help your subcontractors don't involve them directly. For instance, we mentioned the importance of having the right materials on hand at the right time. To that end, confirm prospective deliveries with suppliers a day or two ahead of the sub's arrival.

Also, be sure you have a superintendent on site every time a different subcontractor starts. He or she can answer questions, identify problems and generally get a new sub up to speed on how the project has progressed to date.



Of course, you'll want that superintendent to keep an eye on the sub's work, making sure it's on schedule and up to your quality standards. He or she can also start developing the punch list early so that the subcontractor can correct mistakes and minimize or prevent unfinished work before leaving the job site.

In addition, look closely at monthly payment applications as compared with work completed. Don't just count on the retainer to cover these amounts.

Last, but perhaps most important, involve your banker. That is, pay your subs promptly. If they've done an exceptional job, consider giving them a bonus if the budget allows.

### PROVIDE, DON'T PROVOKE

Building a reputation as a general contractor who communicates early and often, provides assistance rather than provokes problems, and pays on time can quickly move you to the top of your subcontractors' "A" list. And that may be the best scheduling tool of all. 💎

# Wanna go paperless?

*IWA systems may hold the answer*

Ever since computers became an integral part of doing business, people have talked about going paperless. Although doing so has yet to become a reality for most, if any, companies, imaging and workflow automation (IWA) systems may get you one step closer.

With an IWA system, key documents are scanned into a central Web-based storage site where even the most far-flung employees can access them. The benefits for construction companies, whose workers are quite typically far-flung, can be remarkable.



## **STREAMLINING WORKFLOW**

Many business owners, including contractors, have primarily been using IWA systems to streamline their invoice and accounts payable processes.

Employees can scan invoices as soon as they arrive, meaning paper never even gets into the system. (The originals are often discarded, but doing so may have audit implications that you should discuss with your CPA.) Scanning invoices into the system can:

- Reduce data entry errors,
- Prevent lost, misfiled or buried paperwork, and
- Speed up the approval process.

Plus, employees spend less time digging through file cabinets that may not be close to their desks.

Now you may be thinking, “Great, but I already have a scanner. Why do I need an IWA system?” Because your financial and accounting systems probably don’t recognize scanned images.

IWA systems can provide this functionality, converting documents into digital images that anyone with a Web-enabled computer — including your estimating and accounting staffs — can pull from the central storage repository.

After all, it’s cumbersome enough to receive and match paper invoices to begin with, but the process becomes really painful as those papers get circulated through approvals. An IWA system can help matters by allowing you to bring the process to a halt when you need to resolve a discrepancy or allow an exception. Fixing a problem on the spot is usually faster than having to backtrack later on.

## **REDUCING COSTS**

By improving workflow, an IWA system can reduce the cost of document retention. For starters, you won’t need as much storage space, you won’t have to use the mail or couriers to route documents, and you may reduce or eliminate late payment penalties. In fact, you might be able to take advantage of prompt payment *discounts*.


In addition, you can establish predetermined rules to automatically route documents to the appropriate people. Doing so not only speeds job progress, but also guarantees that the right people have the right information at the right time. And with it, they can avoid making the expensive mistakes that plague many a construction project.

*IWA systems convert documents into digital images that anyone with a Web-enabled computer can pull from a central storage repository.*

Similarly, when someone needs a historical perspective on a given issue, the data is immediately retrievable. This can help you identify important business and payment trends and offer you a look at individual or departmental work records to see where bottlenecks are occurring.

## **DARING TO DREAM**

Of course, there are risks to IWA systems. If you rush into the purchase, you might overspend on a solution that, ultimately, provides an unsatisfying return on your investment.

In addition, you’ll need to seriously consider internal controls and fraud deterrence measures regarding the system. Yet, if you dare to dream of a paperless office, an IWA system could make that dream a reality. 

# Tighter mortgage standards threaten homebuilding market

**N**ot too long ago, homebuyers had it easy. Lenders were handing out mortgages to most who applied — even those who couldn't afford down payments or were unlikely to maintain their payments once early “teaser” interest rates went up.

Although some of the financing was risky, a booming housing market meant people could buy homes, keep them until their adjustable rate mortgages (ARMs) were ready to adjust and then sell them at a profit.

Those days appear to be over. Generally, housing prices have fallen over the past year, and many potential buyers are no longer able to readily obtain financing — and this is affecting the construction business.

## **SOGGY SALES**

How bad have things gotten? Of the homebuilders surveyed by the National Association of Home Builders earlier this year, 44% said tighter lending practices had hurt their sales. The median loss reported was an estimated 15%. KB Home, the fifth-ranked homebuilder in the United States, reported an 84% drop in net profit for its fiscal first quarter, which ended Feb. 28.

Some experts say the soggy sales were inevitable. Weaker lending standards in recent years sparked excessive demand and helped fuel the housing boom. And now that tighter standards are in place, the market has predictably fallen into a slump.

The problem is most severe in the subprime lending market, where higher priced loans are marketed to people with credit problems or lower incomes. Particularly problematic are the ARMs, whose rates may jump dramatically out of reach for some ill-informed or unlucky borrowers.



Someone who borrowed \$200,000 at an introductory rate of 4%, for example, would pay about \$950 per month in principal and interest. That might be affordable, but if the interest rate jumped to 7% after a year or two, the payments would become \$1,320. Some borrowers simply can't keep up.

## **SOME GOOD NEWS**

For homebuilders, however, there is some good news. Although lenders reported record mortgage delinquencies and defaults in 2006, the problem was largely confined to the aforementioned subprime market. The prime market, which comprises most homebuyers, hasn't been significantly affected.

*Now that tighter standards are in place, the market has predictably fallen into a slump.*

Additionally, lenders are taking steps to help struggling homeowners avoid foreclosure — and to help prevent further weakening of the market. Fannie Mae and Freddie Mac, the government-sponsored companies that are the two biggest players in the home mortgage market, have agreed to buy billions of dollars in high-interest mortgages. That will give commercial lenders some flexibility to help strapped borrowers.

Also Fannie Mae, Freddie Mac and a number of lenders — including Citigroup, JPMorgan Chase and Bear Stearns — have adopted principles for dealing with high-risk mortgage holders. They include contacting distressed borrowers to try to work out payment arrangements, making loans more affordable through lower rates or changing terms, and refinancing at the lowest cost possible for eligible borrowers.

## **KEEN EYES**

Ultimately, the best thing a homebuilder can have right now is a pair of keen eyes for changes in his or her local market. Learn to distinguish real opportunities from unreasonable risks — doing so isn't as easy as it used to be. ♡

# Now or later: Accounting for claim revenue

Unanticipated income, or claim revenue, is one of the trickier tax accounting problems for contractors who perform long-term jobs — defined by the IRS as those stretching across more than one tax year.

Do you include the claim revenue now (in the year you receive it) or later (in the year you do the work)? The answer lies in your accounting method of choice.

## CHOOSING A METHOD

Generally, long-term contracts require percentage-of-completion accounting, under which you determine your gross income for each taxable year of the contract and then, when the job is done, calculate any look-back interest owed to or due from the IRS for each year.

An exception: If your gross receipts were less than \$10 million for the three years preceding the contract, and the contract will be complete within two years, you may opt for the completed-contract method, under which you recognize both expenses and income in the year in which they are incurred or received. Be advised,



however, that the IRS would not look kindly at switching back and forth between methods, even if your volume fluctuates right around the \$10 million mark.

With the percentage-of-completion approach, you report income over the life of the contract based on the total amount of revenue you expect to receive, and you deduct expenses in the year in which they're incurred. Your revenue estimates are likely to change as the job evolves, but the total contract price should always reflect the amount you realistically expect to bring in.

*If you don't include the right amount of claim revenue in the year in which you do the work, you may be liable for underpaid taxes as well as penalties and interest.*

Under IRS regulations, the total contract price must include claim revenue as soon as you can reasonably predict you'll earn it. Even if a claim is being disputed, you must adjust the total contract price to include the revenue you expect to receive from it — which should be at least as much as your cost to do the work.

Like claims, any early completion bonuses should be included in the total contract price as soon as you're reasonably sure you'll get them. If the bonus, or any other contingent revenue (such as a claim) doesn't materialize, you can deduct that amount in another tax year.

Please note that requirements for financial statements generated under Generally Accepted Accounting Principles (GAAP) differ slightly when it comes to recognizing contingent assets. GAAP typically requires that the contingent asset be more certain before recognition.

## A MATTER OF DETAILS

In deciding what to include each year, it's important to gather objective, verifiable evidence supporting each claim. Your "gut feeling" that you'll make a certain amount isn't good enough. At the same time, if you don't include the right amount of claim revenue in the year in which you do the work, you may be liable for underpaid taxes as well as penalties and interest.

How will you know one way or the other? As mentioned, when you complete a long-term contract, you'll use the look-back method to determine whether you've over- or underpaid taxes or interest. Ask your CPA for help: IRS regulations in this area are complex, and many contractors calculate look-back interest incorrectly, don't calculate it at all or fail to properly file the results.

In simplest terms, when a contract is completed you must reallocate income to reflect actual, rather than estimated, results for each year of the contract. Based

on that reallocation, you can determine whether you've over- or underpaid taxes. If the former, you can receive interest. If the latter, you'll owe interest.

### **EXPERT ASSISTANCE**

If you've been in the construction business for any length of time, you've probably dealt with the issue of how to account for claim revenue. Yet just because it's a familiar matter doesn't mean it's any less risky. To avoid trouble with the IRS, work with your CPA regularly to ensure you're following the rules. ♦

# Construction Success Story

## ***Reconsidering associations and trade shows***

For years, a homebuilder in a moderately growing market has been receiving invitations to join various construction trade associations or to exhibit at regional trade shows. He's typically hurled these letters and pamphlets into his circular file. But, with the housing market tightening, he found himself reconsidering these opportunities.

He mentioned it to his CPA during one of their monthly meetings, asking whether either or both were worth his time. His accountant, who had worked with many other construction business owners in the past, had some pointed advice, including:

**When it comes to trade associations, you get what you give.** The contractor won't get much out of an organization (besides more junk mail) unless he joins a committee or two. There he can get first looks at new business in his area and promote his own construction company while promoting the organization.

If the contractor decides to join a national group, he can benefit from the organization's education and training programs and increase the visibility of his business. There are, however, many construction trade organizations to choose from. He'll need to find the one that's most likely to give him the best return on his investment.

**Trade shows are anything but a vacation.** Here the advisor issued a warning: Heading off to a glitzy hotel or convention center may sound glamorous, but it can be a colossal waste of time if you go in blind. The contractor should have a plan. If he wants to sell spec homes, for instance, he should exhibit photos of his work and be prepared to succinctly discuss why it's better than that of his competitors.

And while he's there, he can be an attendee as well as an exhibitor. Armed with plenty of business cards, he should visit other booths to start making connections that can lead to contracts or joint ventures.

The contractor in this story started small, joining his local chamber of commerce and exhibiting at a local trade show. The effort paid off. He's now gotten to know several key figures involved with the zoning and permit process in his area. And his appearance at the trade show led to at least two new projects.

# The expertise you need, the service you want.

**A**t Smith & Gesteland, LLP we know that running a successful construction company these days requires more than just dedication and hard work. It takes the assistance of experts who understand the industry and the challenges contractors face, and who have the specialized knowledge, hands-on experience and service commitment it takes to help them achieve their business goals.

Our Construction Industry Services Group consists of experienced professionals focused on increasing the success of companies like yours. For more than 50 years, our firm has served individuals and businesses throughout south central Wisconsin. We are delighted to currently work with more than 100 contractors and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

- Profitability improvement
- Cash flow projections
- Quality and productivity enhancement
- Estimating/bidding improvement
- Bonding capacity maximization
- Lease vs. purchase analyses
- Tax reduction strategies
- Business valuations
- Succession and estate planning
- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or mail@sgcpa.com. We look forward to talking with you.

**Smith & Gesteland**<sup>LLP</sup>

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