



Accounting in the Construction Industry

How your CPA can help you be among the 80 percent of contractors expected to survive the next year, rather than the 20 percent expected to fail.

This whitepaper will have special interest to:

- Contractors concerned about their ability to secure future financing.
- Advisors to construction contractors.
- Contractors who realize they need to make permanent changes to their business, but are unsure of the best path to follow.
- Entrepreneurs looking to start a new company built on their construction skills.
- Small contractors whose survival depends on maintaining a strong balance sheet.
- Large contractors looking for CPAs knowledgeable in construction markets to undertake special assignments.

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CPAs AND ADVISORS

Construction-related businesses have long been a haven for some of the most self-reliant and successful people in America. The owners of these companies are used to walking a tightrope over crocodile-infested waters as they navigate complex long-term contracts, low-margins and constant demands on their available cash reserves. Their businesses are so different from others that a totally separate section of the IRS tax code is dedicated to their accounting methods. Even the economy treats contractors differently, affecting them much more deeply and in different ways than other businesses. This whitepaper is dedicated to helping these unique American businesspeople survive an economic landscape that has dramatically changed their industry.

When writing this whitepaper, we considered that many contractors have long-standing relationships with their CPA, whether that CPA started with construction experience or not. However, this is a unique time in the construction business that demands a CPA who not only has construction experience, but also stays current with the rapid-fire changes taking place in construction accounting procedures and the construction business. For example, under IRC 460, contractors working on home construction projects can use either the cash method or completed contract method of accounting, to gain tax flexibility.

At the same time, a severe recession has forced many contractors to radically restructure their businesses. CPAs with deep industry ties are able to help these businesses navigate the new landscape while preparing for the inevitable upturn.

The Tie Between Procedures and Advice

Knowledge of rapidly changing procedures is crucial for success in construction. As the market continues to tighten, many contractors find themselves taking work well below their target margins, and with profits tight, new work often strains their remaining capabilities and resources. Bidding on such tight margins requires a reliable understanding of costs. For example, if a contractor figures insurance covering office contents as an indirect cost, the costs of a job he is bidding on will be too high. At the same time, if he doesn't factor in builder's risk insurance as an indirect cost, anticipated costs for that job will be too low.

In this economic environment, a financial misstep or poor business decision can spell the end of a business that has been operating for decades. Never has it been more critical to work with a CPA who is on top of changes in procedure, understands your business and is respected by your lending sources and surety agents.

How a CPA with Construction Experience Can Make a Difference

A CPA with industry expertise is a must for a business ruled by complex accounting and tax procedures. When you also consider the need for aggressive cash management, reliable financing and expert business advice, the selection of a CPA who combines industry knowledge with business knowledge becomes one of the most important business decisions any contractor can make.

However, there are at least two other considerations for a contractor when searching for accounting and audit services:

- 1. Relationships:** Certainly it's good to work with people you are comfortable with. However, it is more important for your CPA to know and work well with your bankers and surety agents. Since financing is the lifeblood of the construction industry, knowledge of how a surety or bank needs to see financial statements is vital. Time after time we have heard from both that they can tell if a contractor is being advised by a CPA knowledgeable about the construction industry just by looking at how the financials were presented.
- 2. Business Consulting Expertise:** Financial, regulatory, safety and management demands are mounting on every type of contractor. For this reason, we have seen greater use of our consulting services to help contractors keep their businesses running smoothly. This is especially true at a time when the need to right-size presents a whole new set of challenges to contractors. How do you get payroll and overhead in line with business while still maintaining the capabilities required to bid on new business? A good CPA steeped in the contracting business can help a contractor find the right path forward.



Be Prepared for Permanent Changes in the Business

Engineering News Record Magazine recently named the federal government “Owner of the Year” in recognition of the increasing role it plays in the contracting business. Is this temporary or permanent? We don’t pretend to know, but government work requires some specialized knowledge and contractors who want to continue to grow are well advised to master the intricacies of government work.

The credit environment has also changed dramatically. Not only have balance sheets been affected by the recent recession, but we are seeing surety agents and credit sources more hesitant to extend credit to contractors who aren’t getting the right advice. They pay attention to who is doing the financial statements, auditing the books and providing business consulting services.

It has been said that we are in a “reset economy.” This means contractors have to look at what they are doing from an operational point of view. Instead of focusing on cutting overhead immediately, find ways to make changes in estimating or field production. If the target is a 15 percent cost reduction, 12 percent can be realized through these changes leaving another 2 percent to 3 percent to be realized through cutting overhead.

However, contractors have to constantly monitor the situation and be prepared to make other, more dramatic changes. They must adapt. In this entirely new environment, 20 percent of the industry will fail by the end of any given year. However, 80 percent will succeed. How closely contractors stay on top of costs and day-to-day operations will determine which group they fall into.

How a CPA Can Help Contractors Navigate This New Environment

There are three basic things an experienced CPA can bring to any contractor's team:

- 1. Knowledge of the incredibly complex accounting and tax issues facing contractors.** Section 4020 of the IRS Code is among the largest and most complex in the entire code. An experienced CPA should understand all the intricacies. In addition, contractors tend to operate many corporate entities in order to spread risk. As CPAs, we are often called upon to help contractors determine the type of entity best suited to a particular role.
- 2. The ability to properly prepare financial statements required to secure funding sources.** A contractor's access to funding depends on the ability of their CPA to prepare materials in the way funders and sureties need to see them. Since construction funding is very different than other types of financing arrangements, a CPA needs to have experience in the market to do the job properly.
- 3. Consulting support to help them make good decisions at a time when there is little margin for error.** As a contractor once told us, "It would be impossible for me to keep up with all the changes taking place in my business." A CPA with business consulting experience can help a contractor get above the daily grind and understand the ramifications of any decision he or she makes. They can help a contractor understand the proper relationship between direct costs for labor, material and subcontracting and indirect costs for labor, supervision, tools, equipment, supplies, insurance and support costs. This, alone, can be an invaluable service to any contractor caught in the maelstrom of a business where a single misstep can cause ruin.

How Contracting Businesses Are Different

Knowledge of rapidly changing procedures is crucial for success in construction. No two contractors are alike because of the nature of the construction business and the people involved. A contracting business demands a high tolerance for risk; it will not attract people who enjoy painstaking analysis of financial statements. It is easy to understand why contractors tend to be expert at estimating, winning contracts and getting things built, yet less sophisticated about the financial side of their business. As one contractor commented, “I don’t know if I know the business of business.”

Thinking and Working Long Term

Long-term contracts are the norm in almost every type of construction. This makes it difficult to understand when profits are realized. A manufacturer who makes and sells a thousand widgets knows how much income he receives from his investment and when he will realize it.

Contractors working on long-term contracts don’t have this luxury.

This is the reason contractors fall under a totally separate section of the IRS tax code, the single largest and most complex section.

Even within their own code section, contractors are treated differently depending on their size. This change occurred in 1986 when a number of large defense contractors were found to be using the completed contract method of accounting, pushing off any income realization and consequent tax liabilities until the final jet or battleship was built. At this point, a line was drawn between those contractors with gross receipts over and under \$10 million, adding further complexity to construction accounting procedures.

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Safety makes good business sense

In the contracting business, today’s problems often have repercussions for many years to come. This is most evident in the costs a contractor has to pay for worker’s compensation coverage. To a large extent, the cost of this coverage is based on a contracting company’s safety record. If there have been numerous claims, the higher costs could prevent a contractor from winning enough contracts to stay in business. Therefore a construction-savvy CPA will help a contractor understand the financial ramifications of taking short-cuts with safety.

Cash is King

Even in the midst of a recession that has decimated large segments of some construction markets, more contractors go out of business because the money ran out before the work did. In a business where payroll is paid out every week or two, yet payment isn't received until 60 to 90 days later, there is a strong demand to manage cash.

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contractor is trying to determine how to cut budgets or add capabilities as business ebbs and flows.

For this reason, right-sizing the business has become a major concern for today's contractors. This is often a difficult job for contractors who tend to be an optimistic group; a necessary character trait in a business where one poorly executed contract can force a company out of business.

The construction industry is one of the few industries that demand at least three parties to any financing agreement.

The construction industry is one of the few industries that demands at least three parties to any financing agreement. Besides the contractor, a surety agent is necessary in addition to banks and other financing sources. Without good surety and banking relationships, it is virtually impossible for any contractor to compete in today's marketplace.

As guarantors of performance, surety agents have a compelling interest in a contractor's business performance. They want their contractors to work with financial people who understand construction. As one surety agent explains, "Just by looking at a contractor's financial statement, I can tell whether it was prepared by someone knowledgeable about the construction industry. If the statement doesn't have the right numbers in the right place, that contractor is going to have a tough time getting financing and performing to the contract."



The Demands Placed on Construction CPAs

Recently, we talked to a commercial HVAC contractor who told us point blank, “I’m not smart enough to keep up with all the changes affecting my business. That’s why I hire professionals.”

In today’s construction environment, a CPA needs to do more than determine whether to use the Completed Contract Method and Percentage of Completion Method to recognize revenue. We believe they must be able to work as a true partner with contracting clients, and understand the critical relationship between direct costs and indirect, selling, general and administrative costs. A construction-proven CPA must also smooth the relationship between contractors and their financing sources rather than throw up needless barriers. Construction has become a business with very little tolerance for error. A construction-specialized CPA can help contractors safely navigate this new environment.

Conclusion

We wrote this whitepaper to help crystallize some of the financial issues confronting construction contractors today. Few other businesses face the same complex challenges and need for financial clarity. Few place such a premium on industry experience to do the job properly. Contractor's spend their lives walking a tightrope between high costs and demands on cash. An experienced CPA adds an important safety net to help ensure that contractor clients fall into the 80 percent group expected to survive the next year, rather than the 20 percent expected to fail.

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