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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Dimensions

A CPA's Report for the Construction Industry

Spring 2015

Avoiding Boom and Bust

Grow Your Company the *Right* Way

Most contractors who survived the recession did so by slimming down drastically, downsizing their staffs, cross-training employees to perform multiple roles, and working on much tighter margins. Such practices got them through the slowdown, but most agree they don't want to go through that again.

Instead of enduring another cycle of boom and bust, savvy contractors are looking to grow the smart way this time. The goal is to take advantage of today's growth opportunities without overextending and setting themselves up for another round of drastic cuts down the road.

Here are three broad areas of focus where careful management can help you smooth out the peaks and valleys of the cycle and achieve more sustainable growth.

Staff Levels, Experience and Operational Structure

As a cost cutting tool, some contractors let go of experienced employees who were earning higher wages, while retaining less expensive but less experienced staff as a skeleton crew. Others took the opposite approach, holding on to only their most reliable and versatile workers who were capable of performing multiple functions, while releasing less experienced staff who were not as adaptable.

Regardless of which approach you used to survive, the reduced staffing levels that were necessary to get your company through the recession will probably not be adequate to support the potential growth in your business in the coming years. The increase in work flow may also require that support and administrative positions that were combined as a cost-cutting measure a few years ago must now be broken up again into separate jobs.

The key in restructuring and rehiring is to invest in positions and people who can increase both the top and bottom lines. Don't add overhead unnecessarily, but be open to adding staff if the new employees can help you add capacity, improve efficiency, or make better use of the revenue you are bringing in. For example, adding a staffer who can help speed up billing and accelerate your cash flow could result in a positive return on your investment.

Project Size and Scope

Some contractors found it necessary to take on projects outside their traditional areas of expertise in order to keep cash flowing during the slowdown. If this happened with your company, you may find your company's specialties have gradually changed over the years.

Take a fresh look at your limits and areas of expertise, and make sure you have the right staff and experience for the type of work you're now pursuing. Be sure you fully understand the contract requirements and scope of work before finalizing a bid, and ask yourself if the work you're now doing is taking your company in the direction you want it to grow.

Also look at the size of the projects you're taking on. A single, blockbuster project can help boost top line growth quickly, but it also increases your risk exposure. In many cases, a large project can also mean relatively lower margins than you could earn by taking on several smaller projects instead.

In addition, of course, always be sure you have sufficient bonding capacity, as well as adequate capital or credit lines to avoid running into cash flow problems over the course of the job.

Estimating and Job Costing

Many companies have been using the same rates for estimating labor, material costs and overhead for some time. In order to accurately cost a job, it is critical that these rates be updated and customized to reflect your company's current experience and structure.

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Claims Management

Quick Response Is Critical When Disputes Arise

Construction projects are, by their very nature, complex processes with many variables and numerous interested parties. In any such situation, misunderstandings and disputes are inevitable.

As business accelerates these days, disputed claims are also increasing. Common causes include undocumented change orders, scheduling delays, defective plans and changes in site conditions, to name just a few.

Whenever a claim arises — regardless of whether you are filing the claim or defending yourself against it — how quickly and effectively you respond can make all the difference.

Early and Expert Legal Advice

One of the first steps a contractor should take whenever a construction claim arises is to get qualified legal advice. It is important to consult with an attorney who is proficient and specifically experienced in construction claims litigation. This is a highly specialized field in which early advice from an expert can save you time, money and effort — not to mention improve your chances of success.

In particular, look to your lawyer for advice on:

- **The specific terms of the contract and legal notifications required.** Most contracts spell out specific steps you must take in order to give proper notice of a claim and preserve your rights. If these processes are not followed precisely, an otherwise valid claim is likely to be thrown out.

- **The dispute resolution processes that are spelled out in your contract.** Many contracts require you to agree to mediation or binding arbitration in lieu of going to court. In addition to explaining the steps your contract requires you to follow, your attorney can also advise you on the pros and cons of the settlement processes your contract specifies and how they are likely to affect your chances of success.

- The legal precedents in your particular issue. You can run up sizable legal costs pursuing a claim that seems justified to you, only to learn that arbitrators or court precedents have consistently ruled against you in similar cases. This is one more reason why specialized legal expertise in construction claims is so important. An experienced claims attorney can advise you if the claim you are pursuing has a reasonable chance of success.

Documenting and Quantifying Damages

As you prepare to talk with your attorney about your claim, it can be useful to review some general concepts about the subject of damages, particularly as they relate to your accounting and job costing systems.

For example, when you are pursuing a claim you normally must be able to demonstrate certain basic facts to a mediator, arbitrator or court. These include the underlying issue that's driving the claim (such as schedule delays, defective plans, changed site conditions, etc.) and why you believe the party against whom you are filing the claim is responsible for the issue.

You will also need to be able to demonstrate that the damages you are claiming are a direct result of the issue you raised. In addition, you must be able to quantify those damages.

That last point is often more difficult than it sounds — and it's an area where your accountant can be of particular help. While direct costs such as materials and labor can be relatively easy to document, it can be much more difficult to accurately allocate indirect costs such as overhead and administrative expense. You will need solid and detailed accounting and cost tracking systems to be sure you are including all the relevant costs you incurred as a result of the action that drove your claim.

What's more, these costs should be quantified and documented as they are incurred — not weeks or months later as you struggle to come up with accurate numbers. Courts and arbitrators tend to look skeptically at "after the fact" computations and quantification of damages. The inability to quantify damage through contemporaneous accounting records can often cause an otherwise valid claim to be reduced significantly.

Educate your project managers and other key field staff about the importance of recognizing potential claims situations early. This way, you can immediately begin accounting for potential claims-related costs separately. Set up separate cost categories for charging time, materials and allocated expenses as they are incurred, rather than trying to separate out the costs later.

Again, your attorney can offer guidance into which costs should be documented. ■

If you have questions about job costing or other claims-related accounting issues, please call us today to schedule an appointment.

Greener Pastures?

Points to Consider When Working Across State Lines

As a contracting business grows, it's likely that it will eventually begin pursuing work in a neighboring state. When this happens, there are a number of tax, licensing and permitting issues to consider.

On the other hand, if your business already operates in more than one state, you should be aware that in recent years many states have become more aggressive in enforcing tax and licensing requirements. Many companies had been performing work in neighboring jurisdictions for several years before realizing they were out of compliance — inadvertently incurring added penalties and interest.

Whether you are just now thinking of expanding into another state or you already are a multistate business with concerns about compliance, here are some basics to consider.

Income Taxes

To evaluate your exposure to various taxes in another state, you must first understand the concept of "nexus." The term is used in tax law to describe a situation in which a business has a connection or presence in a state, and thus is subject to that state's tax laws.

For income tax purposes, nexus is generally established if your company meets one of three triggers:

1. It generates revenue in the state;
2. It owns or leases property, inventory or equipment in the state; or
3. It has employees working in the state.

Specific nexus requirements vary from state to state. But generally speaking, if your company meets any of these descriptions, you will be subject to state income tax on a portion of your net revenues. Note, however, that the methods used to determine how much of your company's revenue is subject to tax will vary from one state to another.

Sales and Use Taxes

For sales tax purposes, nexus traditionally was established only if your company had a physical presence in the state. That has changed somewhat in recent years, as some states are establishing broader definitions of nexus to include leasing or owning property in the state, or the presence of affiliated companies.

About half of all states currently impose a franchise tax, either in addition to an income tax or as a replacement for it. Many states impose various other non-income-based taxes, such as a use tax, business tax, margin tax, commercial activities tax or gross receipts tax. As with state income tax, it is important to understand the formulas that are used to determine what portion of your business is subject to these taxes.

Withholding and Payroll Taxes

Employees who live in one state and work in another are generally required to pay income tax to the state where they work — which means your company must set up an account and withhold the required taxes in that state. Fortunately, many states have established reciprocal agreements with neighboring states, in which they agree not to impose income taxes on each others' residents. These greatly simplify things for workers and employers alike, but you'll need to check whether such an agreement is in place.

Business and Professional Licenses

If your company does not have a physical office in a state, it may be required to hire a registered agent in the state to obtain the necessary license to do business. As a construction business, you also will be subject to the specific professional or trade licensing requirements of the state and local jurisdictions where you will be working.

The initial license applications often must be accompanied by a financial statement, which in some cases must be audited by a CPA. Experience requirements, examinations, forms and filing fees also vary from one jurisdiction to another. Finally, you must also comply with local project-specific permitting requirements.

The costs for the various fees, licenses and permits may not be prohibitive, but they're not insignificant, either. What's more, the administrative costs required to ensure compliance should also be factored in. ■

Our firm can help you address multistate tax and regulatory compliance issues. Please contact us for more information.

Grow Your Company

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For example, the standard unit costs for labor in many estimating software packages are not likely to accurately reflect all of your specific hard costs, which include hourly wages, employer-paid taxes, Social Security, insurance, benefits and other worker-specific costs. In the same way, your overhead rates and cost allocations should reflect the current financial operations of your company, not just an outdated "rule of thumb."

By reviewing your company's estimating practices and adjusting them to reflect today's growth opportunities, you can help grow your business in a more sustainable way — while remaining flexible enough to respond sensibly to any future slowdowns. ■

For more information on sustainable growth strategies, please give us a call to discuss your plans.

IN 1944, Thomas Saltmarsh, Harold Cleaveland and Charles Gund pooled their talents and modest resources to form a partnership for the practice of accounting. The three founding partners soon established a client base that included large and small businesses, as well as commercial and governmental accounts. Their success was attributed to their guiding principles of honesty and integrity, accuracy and thoroughness, quality client service and, most importantly, the belief that service to the community is an individual as well as a corporate, responsibility.

TODAY, Saltmarsh offers a variety of services — from accounting and taxation to consulting — all based on the Firm's mission statement and core values. It is this philosophy, based on the principles of yesterday, that has helped the Firm grow to one of the largest locally-owned certified public accounting firms in the Southeast.

SALTMARSH CONSTRUCTION ADVISORS are here to meet the specific needs of contractors, home builders and related trades within the construction, real estate and development industries. Because we truly understand construction accounting and financial management, contractors and developers of all sizes and different trades rely upon our experience. Need assistance? Contact the construction advisors at Saltmarsh or call us today at 800.477.7458.

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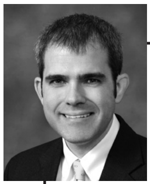

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How Grouping Can Avoid the Medicare Surtax

The Net Investment Income Tax (NIIT), also known as the "Medicare surtax," went into effect back in 2013. It imposed a 3.8 percent surtax on net investment income of certain high-income taxpayers.

As the construction industry recovers, many contractors could discover that their modified adjusted gross income (MAGI) exceeds the triggering thresholds for the first time. If so, they could find themselves unexpectedly subject to the tax. This is especially true if they operate several construction-related businesses instead of just a single company, as is often the case.

The surtax applies only to "net investment income," a term that encompasses interest, dividends, royalties, rents, capital gains and other passive income. Since self-employment income from an active business is generally not considered passive income, most contractors might assume that income from their construction businesses is excluded.

However, this may not be a safe assumption if you operate several businesses. There are various tests to determine if a taxpayer is materially participating in a business and thus not receiving passive income. The most commonly cited test is whether the taxpayer participates in the business for 500 hours or more per year, or about 10 hours per week.

That doesn't sound like much time, but a contractor who divides his or her time among several construction-related businesses could actually spend less time than that on one or more of them.

Fortunately, the IRS allows taxpayers to group several related business activities together for purposes of satisfying the material participation rules. There are very specific requirements and procedures for making this choice. As a general rule, once you have grouped activities, you may not regroup them differently in subsequent years. ■

There are several other effective strategies that could help minimize your NIIT exposure. Call us today to learn more.