Saltmarsh
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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Dimensions

A CPA's Report for the Construction Industry

Summer 2016

*Indirect Cost Allocation*

# Finding Your True Bottom Line


**Most contractors are very careful** to keep a close eye on project costs such as labor and materials. But direct job costs like these are only part of the picture.

It is equally important to have a clear understanding of indirect costs such as rent, utilities, taxes and insurance. These costs must be accurately and consistently allocated among the various projects the company undertakes.

Determining the proper allocation of indirect costs can be a complicated process – but a very necessary one. Accurate cost allocation helps give management a clear understanding of the company's true bottom-line performance and the actual profitability of individual projects. It also is required by nearly all lenders and sureties, who expect to see financial statements that are compliant with generally accepted accounting principles (GAAP).

Bear in mind that a cost allocation method that is GAAP-compliant is not necessarily the correct method to use for tax purposes. GAAP and tax accounting can be two very different functions so the GAAP methods discussed here are not necessarily the correct methods to use for tax compliance.

## Identifying Indirect Costs

The first step is to identify which indirect costs are to be allocated among the company's various projects. These would include any production-related costs that are incurred on a company-wide basis and cannot be traced directly to a specific project.

Common examples include rent, utilities, depreciation and similar costs associated with production facilities such as storage buildings or assembly plants. Other costs that are typically allocated include depreciation, repairs and maintenance of equipment and vehicles that are used company-wide, rather than being assigned exclusively to one project.

General project management and supervision, quality control and inspection, small tools and general construction supplies are also considered indirect costs. Contractor's liability insurance, some employee payroll taxes, workers compensation insurance and other benefit costs should also be allocated.

Note that it may not be appropriate to include certain general and administrative (G&A) costs, such as salaries for administrative personnel whose duties are not actually related to the construction process. Most of today's construction accounting software can discern such personnel-related costs and allocate them appropriately.

## Creating Cost Pools

The various indirect costs are then aggregated into designated cost pools. These are groups of related costs that can be allocated equitably to the various projects. In some companies, all the indirect costs can be grouped into a single cost pool. In others, grouping all costs together could produce a misleading picture of each project's profitability.

For example, if a highway and heavy equipment contractor subcontracts out some of its work to other companies, its own equipment is not used. To avoid overcharging company-wide equipment costs to projects where equipment is not used, the company would create a separate pool for equipment-related costs and allocate them accordingly.

## Choosing an Allocation Method

With the indirect cost pools established, the next challenge is to deter-

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*Managing for Success*

# As Business Picks Up, Cash Flow Is Critical

**With many industry analysts** projecting the remainder of 2016 to be a positive period for construction companies, contractors might feel they have good reason to feel optimistic. Ironically, this type of environment presents its own unique risks.

As you gear up for greater volume, cash flow management is critical. This is especially true when it comes to managing project start-up costs. Don't let enthusiasm influence your judgment or lead you to assume everything will work perfectly. If you do, even a slight payment delay on one major project could lead to serious problems.

## Choose Customers Carefully

One of the most dangerous mistakes an eager contractor can make is to take on a project without ensuring that funding is in place. Contractors that fail to verify project financing can find themselves acting as interim financiers, fronting the money for project costs while they wait months for payment. That's a role few contractors are prepared to handle.

Start with a thorough credit check on the owner of the project. Be particularly alert to past litigation and any history of liens on older jobs.

Your bank and bonding company can also be good sources of information. Under certain circumstances, they might be willing to approach the project's lender for updated project funding information.

If possible, get permission to confirm the project's funding directly with the financing source and continue monitoring funding after you win the bid.

## Get Off to the Right Start

Once you've won the contract, a good preliminary meeting with the project owner or developer and the lender can help prevent cash flow problems down the road. Discuss in detail how you will be paid and be clear about what documentation will be required. Subcontractors should conduct a similar meeting with the general contractor.

Lenders, sureties and owners are sometimes willing to negotiate certain issues, such as the amount of retainage or lender set-asides. Don't be afraid to ask for an exception to standard practices.

One of the primary tools general contractors use to help reduce cash flow risks is the inclusion of "pay when paid" clauses in their subcontractor agreements. With these terms, subcontractors share some of the cash flow risk, since payment is not due to them until the general contractor is paid.

In preparing cost forecasts, general contractors should pay special attention to expenses that are not covered by such clauses. Examples include direct labor and burden, equipment costs, fuel, supplies and some project materials (depending on the contract).

## Stay Vigilant

After work commences, contractors and subcontractors alike should be careful to pursue recognized best practices to maintain adequate cash flow. For example:

- **Always invoice promptly.** Be sure you understand the billing cycle of your payment source and schedule your invoices accordingly. Missing a cut-off date by just one day could cause a 15- to 30-day delay in payment.
- **Document change orders thoroughly.** Contractors must always be alert to requests that are outside the original scope of work. Document such requests immediately and thoroughly. Don't wait and allow memories to fade.
- **Submit change orders without delay.** Waiting until the end of the project to submit batches of change orders greatly reduces your chances of getting paid in full. Once the work is complete, you have little leverage — and other cost overruns may compete for the remaining funds in the budget.
- **Follow collections closely.** Track pending invoices carefully and notify the payer immediately if payment terms are not met.
- **Protect lien rights.** The deadline for filing a contractor's lien is set by statute. If you miss it, you no longer have a valid claim. To avoid misunderstandings, let the owners know in advance that you file liens automatically *without exception* whenever a deadline approaches.

Finally, stay informed about your payment source's financial health. If you're a general contractor, pay attention to the status of other projects the owner or developer is building. If you're a subcontractor, stay alert to the contractor's standing among other trades.

Keeping your ear to the ground can provide valuable early warning of an imminent problem. ■


*Our firm can help you develop and implement sound cash management practices. Please call us to discuss strategies in more detail.*

*Is an IRS Audit in Your Future?*

# What to Do When the Tax Man Comes

**Out of nearly 200 million tax** returns filed by American businesses and individuals in 2015, the IRS audited about 1.4 million returns — or less than 1 percent. While these odds sound encouraging, they're small comfort if you're one of the unlucky few.

What should you do if you receive notice that the IRS is auditing your company's return? Here are seven points to remember:

**1. Don't be scammed.** If you receive a telephone call informing you that the IRS has initiated an audit or some other action against you or your company, just hang up. Such calls are identity theft scams. The IRS never initiates an audit by telephone. Once an audit is actually underway, there might be follow-up phone calls, but the initial notice of an audit always comes by regular mail.

**2. Call your CPA immediately.** This is by far the most important advice to remember. From the moment you receive the notice of an audit, you should never respond directly to the IRS on your own. Send your CPA complete copies of everything you receive and let him or her handle all communications.

You'll be asked to sign IRS Form 2848 (Power of Attorney). This form makes your accountant the primary contact for your audit, with full authority to handle all discussions, information requests and negotiations.

**3. Understand what's in store.** For individual taxpayers, the vast majority (72.6 percent) of IRS audits in 2015 were "correspondence audits" — written inquiries or examinations that typically are handled by mail with few complications. But that's not the case for business returns.

Out of nearly 10.3 million tax returns filed by C corporations, S corporations and partnerships in 2015, the IRS selected 62,568 to be audited. Of those, 77.9 percent were in-person "field audits."

**4. Always meet off site.** A field audit should always be conducted away from your place of business — ideally, at your accountant's office. In some cases, the IRS might request that the audit be conducted in their own offices. Although that's not ideal, it's still preferable to having them on your premises.

Here's why: When IRS auditors are in your office, it's easy for them to come across peripheral information that could open up new avenues of inquiry. Allowing your CPA to host the auditors helps ensure that the only information provided is directly pertinent to your case.

**5. Don't be rushed.** When the IRS schedules an audit, don't be surprised if your accountant requests an extension. It's only natural to want to get the audit behind you quickly, but time is on your side. You have every right to request a delay to make sure all information you provide is accurate, complete and responsive to their inquiry.

*Enter the process with the understanding you may end up paying some additional tax.*

**6. Have realistic expectations.** With a tax code that runs into the thousands of pages, there's a good chance IRS auditors may find something amiss in your return. In 2015, only 30 percent of C corporation returns that were subjected to field audits survived the process with no changes. So you should enter the process with the understanding that there's a good chance you may end up paying some additional tax.

**7. Stay calm and professional.** This can be difficult advice to follow, but it's important to remember the old saying: "It's not personal. It's just business." Bear in mind that IRS auditors are only doing a job – and that they're also human. Hostility or antagonism is likely to provoke a similar reaction on their part. ■

## Indirect Cost Allocation

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mine a method for allocating those costs equitably across all projects. Every company's cost structure is unique, so no single method is right for every contractor.

The most common method bases the allocation on direct labor costs or hours. In theory, the direct labor costs for each project are compared to the company's total direct labor costs for the year. The indirect costs are then allocated using the same ratio.

As a practical matter, contractors typically look back over the previous year and calculate a burden rate (a set amount per labor hour) that reflects this ratio. This burden rate is then applied against the job as direct labor costs are incurred.

When work is assigned to subcontractors rather than self-performed, direct labor costs do not provide an accurate basis for indirect cost allocation. So many contractors develop more sophisticated allocation formulas that factor in material costs or other significant cost drivers.

### A Rational, Systematic Approach

Regardless of which drivers and formulas are chosen, the burden rate and overall cost allocation methodology should be reviewed on an annual basis (at a minimum) to verify it is still accurate and appropriate to your company's situation.

Above all, it is important to develop a GAAP-compliant method that is rational and suitable for your situation and then apply that approach systematically and consistently, year after year. ■

*Contact us for professional guidance in reviewing your cost allocation methods.*

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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# Estimating and Bidding Checklist: Five Best Practices

**Do you regularly lose out on** desirable projects because you've been underbid? Or do you frequently submit the lowest bid among your competitors — only to run into cost overruns once the work gets underway?

Here are five best practices to bear in mind as you review your estimating and bidding practices:

**1. Bid realistically.** Never force a bid – instead, prepare your estimates based on realistic cost and profit projections, not "what the market will bear." Resist the temptation to come up with a target and then ratchet down your cost estimates to meet it.

**2. Independently check all specifications, plans and drawings**. You want to make sure everyone is on the same page. If the project owner comes back with revised drawings after you've already started the estimating process, be sure your estimators capture all the revised data.

**3. Track bid spreads.** If you were significantly underbid by a competitor, you'll want to know why. But it can be even more important to track the spreads on the contracts you win.

Greatly underbidding your competitors can be a warning sign that you overlooked something important. The sooner you figure out why, the sooner you'll be able to find a solution.

**4. Involve project management personnel in the estimating process.** Ideally, the project manager who will be running the job should be involved from the outset.

This helps ensure the project manager clearly understands what was promised to the client. An experienced project manager can also provide valuable insights to the estimators.

**5. Regularly evaluate past performance.** A complete post-project review gives estimators specific information they can use on future bids, rather than relying on general industry standards that may not be achievable in your company. ■

*Would you like to discuss estimating practices in detail? Please call us to schedule an appointment.*