March/April 2002

contractor

SMART STRATEGIES FOR HARD TIMES

How to stay in the black without seeing red

You can deduct prepaid expenses … CAN'T YOU?

2 tech breakthroughs to definitely consider

PLUS!

FREE supplemental report on choosing construction accounting software (see response form inside)

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don’t fear the “r” word

Surviving a Recession Calls for Decisive Action

Hard times can seem twice as hard to contractors, because your success depends on so many different economic aspects. For example, homebuilders struggle if homeowners face an income crunch and refinance their mortgages instead of buying new. Commercial builders suffer if businesses slow expansion, perhaps even downsizing staff to avoid a move. And let’s not forget government work — it may diminish because state and county governments must curtail capital improvements to stay within budget.

But all hope is not lost. Construction companies have survived recessions in the past and can surely do so in the future. You simply need to find ways to cut costs and maximize profits on the jobs that do come your way. Here are some ideas that other successful construction companies have used to take the fear out of the “r” word and keep their balance sheets in the black.

BROADEN SERVICES, TIGHTEN PROCEDURES

Many contractors believe that, to market themselves, they must specialize in a particular type of construction, such as restaurant building or underground excavation. But during economic slowdowns, you may need to revise this paradigm. Diversifying your client base can help you survive hard times — much like owning a large rental property with a few vacancies is better than owning a small one in which even one vacancy can mean disaster.

Yet as your client base expands, your project management must tighten. Otherwise, your schedules will drag and your costs may rise to the point where you’re losing money instead of making more of it. To improve your project management:

Amend your estimating. Now more than ever, your estimators need feedback regarding how their bids are actually coming in. If you expect a lower business volume this year, ask them to consider refining their overhead rates — you may need to ensure that prospective jobs provide more value before they’re worth accepting. And be careful about taking breakeven jobs to keep busy. These projects may tie up valuable resources if more profitable jobs come along or create more risk than is wise in lean times.

Polish procurement arrangements. Your procurement process — how you obtain and how much you spend on materials and small equipment — may seem inconsequential. But added up over a year or even a few months, procurement costs can pack a powerful punch. To manage these expenses, communicate with your vendors and suppliers. Times are probably a little tougher for them, too. They may be willing to cut you a deal in exchange for long-term loyalty. Some vendors may let you go an extra 30 days interest free instead of drawing on your line of credit. But don’t wait too long: You do not want them to label you “C.O.D. only.”

Check into change orders. Successful contractors create and bill change orders almost immediately after they identify the project variation. Prompt billing keeps the change fresh in the owner’s mind and typically facilitates payment. The secret to effectively managing change orders lies in your projects’ paperwork. Follow your construction contracts to the letter and document everything.

Better your billing. For cash flow reasons, try to prebill your jobs. Although billings in excess of costs and estimated earnings (BIE) appears as a balance-sheet liability, it creates cash flow from jobs in which you bill beyond your actual progress. For instance, you can create BIE by arranging — and billing for — an early materials shipment before you need to pay the supplier. Emphasize the delivery’s importance and stick to the established price. Remember, owners are often willing to pay for peace of mind, knowing that materials shortages will not delay a project.

Galvanize your gadgets. Technology improvements can allow you to decrease costs without a massive hardware and training investment. For example, wireless communications and Internet-based tools greatly decrease the waiting time associated with subcontractor arrangements. Some contractors have even saved big by just reviewing their phone bills and changing telecommunications companies.

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MAKE THE MOST OF YOUR MONEY

Of course, a wide customer base and optimal project management means little if you mismanage your money. Previously, you may have depended on models, such as only paying your subcontractors when you get paid or keeping accounts receivable larger than accounts payable, to regulate your cash flow. Perhaps you now need to up the ante. Many of today's accounting software packages include often overlooked budgeting models in their general ledger applications. And most include a function that easily adapts to your historical data.

Or, better yet, call us. We can help you set up simple spreadsheet models as well as actual and projected income statements in which we convert net income to cash flow and then direct these amounts into projected balance sheets. In fact, you can use this information to monitor and project not only cash flows, but also your bonding capacity (typically eight to 12 times working capital) and your borrowing base.

After all, you need to know more than just how much room you have on your line of credit. You also must stay aware of how many weeks it will remain at current work levels before you need help. Generally, bankers and bond agents will work with you as long as you give them plenty of notice. Plus, contacting them before trouble hits demonstrates your management ability and gives them more time to better serve you.

One caveat: Don't forget to pay your CPA! (We had to get this one in here.) If you've not yet paid the previous year's audit fee, then your CPA cannot issue your financial statements. According to professional accounting standards, an auditor must have received payment for the previous year's audit fee to remain independent and able to conduct an audit. Typically, bankers and bond agents insist that an independent party has performed an audit to appease their lending boards and underwriters and to keep working with you.

PANIC BAD, PLANNING GOOD

The economic outlook is indeed partly cloudy, but this is no time to panic. Rather, take a fresh look at your bottom line. Revising how you manage jobs, as well as how you allocate and time your financials, can eliminate any excesses that built up when the economy was a bit more vibrant.

The ideas we've presented here are but a few of the many strategies we can help you implement. And by looking at your construction company's unique strengths and challenges, we can devise many more. Please call us for help.

CUT COSTS AND ENHANCE YOUR WORK FORCE WITH CONTINUING EDUCATION

It's common knowledge that employee training is among the best investments any company can make. And even in today's tougher economy, this still holds true. But did you know that you can actually use employee training to *cut* costs?

Like many contractors, you must often curtail temporary layoffs because you can't afford to lose qualified people. Yet you face escalating payroll costs for employing idle workers. Here's a solution: Consider filling their time with internally prepared training programs — such as OSHA safety regulation classes, technical workshops and teambuilding exercises. By doing so, you'll not only increase their value as employees, but also keep them from jumping ship to your competitors.

Truth is, many of your managers may already possess significant leadership and teaching skills but have lacked large group settings in which to share their ideas. And by helping them advance on the construction-skills learning curve, your staff will stand ready to lead the charge when the economy turns the corner.

can cash-basis contractors deduct prepaid expenses?

For many years, contractors have fought the IRS for the right to use the cash — as opposed to the accrual — method of accounting. The IRS recently announced that until it issues further guidance, it will not challenge use of the cash method for many construction businesses — particularly those involved in paving, painting, roofing, drywalling and landscaping. Yet a critical question related to the cash method still remains unanswered.

Say Think-Ahead Construction Co., a cash-basis taxpayer, prepaid many of its annual expenses for materials. By prepaying, it was able to fix these upcoming costs and even negotiate a discount. That's great news for Think-Ahead. But, come tax time, can the company deduct these prepaid expenses on its tax return?

THE ONE-YEAR RULE

The tax treatment of prepaid expenses generally follows the "one-year rule." It states that, as a cash-basis contractor, you can usually deduct prepayments for materials and supplies as long as the period to which the payments apply is one year or less. Also, you must be able to show:

- The expenditure is an actual payment — not a refundable deposit,
- The prepayment is for a substantial business purpose and not merely to avoid taxes, and
- The deduction does not materially distort income.

For instance, you could typically deduct prepayments for a license or permit that your company will use during the next 12 months. But the rule doesn't apply to all such expenses. One company tried to claim a prepaid expense deduction when, to cut costs, it bought vehicle tires in bulk. The IRS denied the deduction, pointing out that tires have an average useful life beyond one year.

2 TYPICAL IRS ARGUMENTS

Although the one-year rule has garnered much support from the Tax Courts, it remains a guideline — not a law. Therefore, you cannot assume that, based on it, you'll automatically qualify for a deduction. The IRS still often disagrees with prepaid-expense deductions and, historically, has used two arguments to disallow them:

3 PRECEDENTS TO CONSIDER

The construction business isn't alone in its fight to fully deduct prepaid expenses. Other businesses that use the cash method of accounting have struggled for this deduction. Here are three noteworthy precedents that we believe offer hope to contractors who wish to claim this deduction:

Van Raden v. Comr. Our first precedent comes from the feed industry, but a Tax Court could eventually apply it to the construction business. In this case, a farmer prepaid his feed costs because he arranged a favorable deal with his supplier. The Tax Court stated that "a substantial legitimate business purpose satisfies the distortion of income test" and held for the taxpayer, because the prepayment's primary purpose was to lock in the price for a year's feed supply.

Packard v. Comr. Another feed industry case also turned out favorably for the taxpayer. Here the Tax Court framed the issue as whether the prepayment's primary purpose was tax avoidance, stating that "[a] business purpose exists if the prepayment fixes maximum prices for feed, secures an adequate feed supply or secures preferential treatment in anticipation of a feed shortage." The Court did not find that the prepayment's primary purpose was to avoid taxes, though tax considerations clearly motivated the parties involved.

Keller v. Comr. The oil industry offers us another look into the issue. In this case, a drilling company prepaid expenses to a related party. The Tax Court concluded that deducting the "real" prepayments of intangible drilling costs clearly reflected income based on a business-purpose analysis. Thus, the Court ruled in the taxpayer's favor, noting that the drilling contracts at issue locked in prices and effectively shifted the drilling risks from the partnership to the driller. The Court also asserted that a cash-basis contractor who prepays expenses that apply to a period of more than 12 months generally cannot deduct the full amount in the payment year, but must prorate the expense over the asset's life or for the duration of the purchased services.

Perhaps the most critical issue for Uncle Sam is whether the prepayment is reasonable in the context of the agreement between the parties and the industry's practice.

No legitimate business purpose exists for the payment. Perhaps the most critical issue for Uncle Sam is whether the prepayment is reasonable in the context of the agreement between the parties and the industry's practice. Previous court cases have shown that a legitimate business purpose does exist if the payment guarantees supplies or protects against future price fluctuations. Conversely, a voluntary prepayment — one made before it is due under the agreement — presumptively lacks business purpose.

Particularly in related-party arrangements, the IRS may look beyond the question of when a payment is normally due to the issue of whether the contract itself jibes with commercial norms. For instance, it ruled against a drilling company that prepaid expenses to a related party. The IRS asserted that this practice was "not in accordance with customary business practices" and disallowed the prepayment deductions.

Allowing a current deduction for such payments fails to clearly reflect income. Citing Regs. Section 1.461-1(a)(1), the IRS has occasionally prohibited contractors from deducting "expenditures result[ing] in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year." Strictly speaking, this provision imposes a capitalization requirement; lawmakers probably intended it to apply primarily to "period costs," such as interest and rent.

Fortunately, drawing a distinction between "period costs" and "product costs," several courts have rejected the IRS's position. For instance, one Tax Court allowed a farmer to deduct animal feed as a current expense because of the traditional leeway accorded to cash-basis farmers. (To read more examples of recent cases, see "3 Precedents To Consider" on page 4.) Similarly, the Courts have emphasized that for other "nonperiod costs," such as the intangible drilling expenses mentioned earlier, whether a prepayment is a capital or current expense is a separate issue from whether a deduction for a current expense is allowable in the year of payment. One hopes contractors will also enjoy such favorable treatment.

PROBABLY, BUT POSSIBLY NOT

Thanks to the one-year rule, you can probably deduct many of your prepaid expenses. Unfortunately, the IRS will likely continue to challenge cash-basis contractors on this deduction — even if their prepaid expenses meet the rule's criteria. To put yourself in the best position, choose an amount that is not too large and has an acceptable business purpose (such as to lock in a good price).

This deduction may seem immaterial to your financial statements, but it significantly affects how many tax dollars come out of your pocket. Please call us to discuss this issue in greater detail. And if you have average gross receipts of less than $1 million, we can help you with Revenue Procedures 2000-22 and 2001-10 — whereby accrual basis taxpayers may automatically change to the cash method.

catching the technology wave

2 Groundbreaking Strategies To Consider

Contractors have a reputation for being slow to change. Despite myriad improvements in business technology, many construction companies still struggle with a host of seemingly anachronistic inefficiencies — including materials shortages, idle equipment and trade stacking. One reason for the construction business' sluggish technological progress is lack of publicity. Besides office software and personal digital assistants, technology tools for contractors don't get a lot of press. To shed some light on this important matter, here are two examples of how real-life contractors have used technology to greatly improve their businesses.

THE WEB-CAM VISIONARY

A general contracting company that specialized in larger commercial buildings for retail outlets needed to manage multiple job sites across the country. Among the business's biggest problems was monitoring projects from its headquarters without having a foreman on site 24 hours a day. The solution? For about $10,000, the company installed a "Web cam" — a video camera that feeds images directly to the World Wide Web — on one of its job sites. (They could move the camera to other jobs as well.)

Besides office software and personal digital assistants, technology tools for contractors don't get a lot of press.

One immediate benefit the contractor found was communicating with subcontractors. For example, when a subcontractor said he had 10 masons on the site, the general contractor could say he was looking at the job right now and could see only four. The construction-company owner merely had to pull up the real-time image to verify other aspects of the job as well — such as whether materials had been delivered or whether to approve a change order.

Also, the Web cam had a remarkable marketing benefit. Because it uploaded images to the general contractor's Web site, project owners could simply visit the site to view their respective jobs-in-progress. In fact, owner payments dramatically improved following the camera's installation. Ultimately, the Web-cam technology's $10,000 cost was a small percentage of total job costs that paid for itself, and then some, in improved efficiency.

THE SPEC-AND-BUY REVOLUTIONARY

Another contractor — with a much different specialty — also greatly improved its operations via the bold use of technology. This company sells cabinets to carpenters, and it wanted to expedite how its wholesale customers select and specify their cabinets' designs and dimensions. So, the business set up a simple procurement system called "spec and buy." It grants preapproved buyers a user name and password with which they can log onto the company's Web site and complete an online form specifying what they want and where they need it delivered.

This strategy garnered the company success particularly in the multifamily housing market, where the contractors who build or remodel multiple units can order cabinets for several projects in one easy online visit. The cabinet builder intends to soon enhance its Web site by allowing customers to submit drawings; designers will use them to custom build cabinets to fit in the designated spaces. This spec-and-buy technology has been rapidly evolving in several industries, and construction is finally catching the wave.

RIDE HIGH … HIGH-TECH

As you can see, endless ways exist to integrate technology into any construction business. Please call us; we can help you pinpoint the concepts and tools that will best serve your company. And to learn about another important technology issue — choosing an accounting system — fill out and fax back the reverse side of this sheet. We'd like to send you a free copy of our *Management Insights* report, "Getting It Right the First Time: 3 Steps to Selecting Construction Accounting Software."

See other side for more ways to improve your construction company's profitability …

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