Winter 2022

CONSTRUCTION INDUSTRY ADVISOR

Construction accounting

5 ways to optimize your financial reporting

Why contractors should consider mediation

Combating the skilled labor shortage

Pump up tax savings with the fuel credit

Gelman LLP
Certified Public Accountants
& Business Advisors

1 Park Plaza STE 950
Irvine, CA 92614
Phone 714-667-2600
Fax 714-667-2636
www.gelmanllp.com

Construction accounting

5 ways to optimize your financial reporting

In today's challenging environment, a construction company's relationships with its lenders and surety are more important than ever. One way to enhance these relationships is to optimize your financial reporting to ensure it provides the information that lenders and sureties need to feel comfortable extending credit and bonding to your business. Here are five ways to optimize the process.

1. Prepare timely, high-quality financial statements

This may seem obvious, but sloppy financial reporting is a big red flag for financial statement users. Regardless of your company's financial health, lenders and sureties will hesitate to extend credit unless your statements are complete, accurate and timely. And that also goes for additional documentation such as work-in-progress (WIP) schedules and owners' personal financial statements.

Don't view financial reporting as only a once-a-year activity. Dedicate yourself to preparing high-quality interim financial statements throughout the year. Lenders and sureties hate surprises; solid monthly or quarterly financial reporting will minimize the need for year-end adjustments.

2. Benchmark your performance

Compare current financial statements to previous years' statements as well as to industry data from comparable companies.

Benchmarking against your own results can reveal trends in financial performance over the years — both positive and negative — and reveal potential reporting errors. You may discover opportunities to improve your financial reporting as well as to

reduce debt, speed-up collections, or correct a pattern of under- or overbilling.

Benchmarking against industry data lets you see how your financial statements and key performance indicators stack up against the competition. Compare key ratios — such as debt-to-equity, return on equity, working capital turnover and current ratio (current assets to current liabilities) — to those of construction businesses of similar type and size in your geographic region. Benchmarking can serve as an early warning system that enables you to address financial weaknesses before it's too late.

3. Boost working capital

It's not enough to be profitable on paper or have a healthy net worth. Financial statement users also want to see solid working capital and a strong cash position, which reflects your ability to fund current operations.

Working capital is defined as current assets minus current liabilities. Current assets include cash and assets readily converted into cash — such as short-term receivables and certain inventory — in contrast to illiquid assets, such as buildings and equipment. In assessing working capital, lenders and sureties usually discount riskier assets, such as

old or related-party receivables or prepaid expenses.

There are many strategies for improving working capital. Examples include accelerating collection of receivables, negotiating more favorable payment terms with vendors and suppliers, and refinancing short-term debt with long-term debt.

Consider preparing comparative financial statements

Lenders and sureties typically ask for several years of financial statements to look for trends and patterns. That's why it's a good idea to prepare comparative financial statements, whether users ask for them or not.

These statements present figures from previous periods, along with the latest figures, in side-by-side columns. This helps users identify and evaluate trends. To further enhance analysis, they may also include columns that show the variance and percentage changes between periods.

Along with providing valuable information to lenders and sureties, comparative financial statements provide your construction business with a powerful management tool.

4. Closely monitor current jobs

Among the most important documents for lenders and sureties is the WIP schedule, which tracks contract price (adjusted for change orders), costs incurred to date, estimated job costs, estimated gross profits, revenues recognized, percentage of completion, billings to date and other information for ongoing jobs.

Preparing and analyzing periodic WIP schedules can help you spot problems and address them before they can escalate out of control. For example, a WIP schedule may reveal jobs are underbilled, which could signal lax billing practices, cost overruns, management inefficiencies or an unhealthy number of unapproved change orders.

Reviewing and comparing WIP schedules and completed contract schedules over time can also uncover unhealthy trends such as profit fade — that is, gross profits that decline over the life of a project. Profit fade is a red flag for lenders and sureties, so it's important to address promptly. Potential strategies include improving estimating practices (or using more conservative estimates) and fine-tuning procedures for managing change orders. Speaking of which …

5. Get a handle on change orders

Policies and procedures regarding revenue recognition, particularly with respect to unapproved change orders, can have a big impact on financial reporting.

For projects with frequent change orders, a conservative approach — that is, recording revenue only when change orders are approved — can distort your financial statements. On the other hand, an approach that's too aggressive can mislead financial statement users regarding the revenues you're likely to collect.

Many construction businesses take a middle-ground approach, recording revenue on unapproved change orders at the lesser of the estimated amount expected to be approved or their actual costs to perform the change order.

Regardless of your approach, explain it clearly to lenders and sureties so they understand the extent to which your financial statements include revenue on unapproved change orders. The more information you provide to financial statement users about your revenue recognition policies, the more comfortable they'll be.

Communication is key

Even if business is booming, the best way to make lenders and sureties comfortable with your financial statements is to maintain ongoing communication about developments — good or bad — that affect your performance. This demonstrates not only good faith, but also the fact that you're regularly engaging in effective financial reporting. Your CPA can be an invaluable advisor in this effort. ■

Why contractors should consider mediation

When a construction dispute arises, among the first thoughts that may come to mind is, "Oh no, is this going to wind up in court?" Sometimes that eventuality is unavoidable, but there's often a much easier and even productive way to resolve the matter — mediation.

Developing strategies

In mediation, a neutral mediator facilitates a settlement that's acceptable to both parties. The mediator meets with the parties in informal joint sessions — and possibly separately — to help them explore relevant facts, issues, positions, needs and options.

A mediator might identify obstacles, point out overlooked issues and develop resolution strategies. He or she doesn't give legal advice or resolve the dispute. Instead, the parties must attempt to reach a settlement themselves with the mediator's assistance.

The parties to the dispute select the mediator — typically a practicing attorney, retired judge or other professional. Working with a mediator who has experience and expertise in real estate and construction can expedite the process and foster the introduction of options not previously considered.

Negotiating an agreement

Typically, the mediator begins with an opening statement, which includes introducing the attendees and reviewing the procedures, ground rules and goals. The parties then make their opening statements. These commonly:

- Describe their understandings of the dispute,
- Present their cases, and
- Suggest ideas for a resolution.

Next comes the joint discussion in which the mediator speaks with the parties about the information in their opening statements and determines which issues to address. Each party then meets separately to assess the strengths and weaknesses of their respective positions.

At the joint negotiation stage, the mediator reconvenes the parties to negotiate face to face. If an agreement can be reached, the parties put it in writing and either sign the document or have their attorneys review it. Such agreements, once entered into, are enforceable as contracts. If no agreement results, the mediator reviews the process and discusses available options, including holding another mediation session or elevating the matter to arbitration or litigation.

Working together

A good mediator will take a neutral stance but actively encourage the two parties to collaborate rather than sit back and challenge one of the parties to "win the argument." In this way, mediation is less adversarial than arbitration or litigation.

What's more, lawsuits can take months, if not years, while mediation rarely lasts longer than several days. And parties can speak for themselves, which can lead to creative solutions not possible

in an adversarial setting. A mediator's evaluation of the strengths and weaknesses of a case can change perspectives about the odds of winning in court, paving the way for settlement.

Further, mediations are conducted confidentially. Statements and evidence used generally can't be admitted as evidence in subsequent litigation, and mediators can't be compelled to testify. Avoiding a courtroom also means parties aren't subject to legal precedents or the rigid structure of litigation. Mediation doesn't involve formal rules of evidence or the question-and-answer format of a trial.

Moving on to arbitration

Mediation is often used with the understanding that the parties will move on to arbitration if one or both can't be satisfied.

Arbitration tends to be less formal than litigation, but it can include discovery and the use of legal standards. Before arbitration, the parties stipulate locale, confidentiality, rules of evidence and issues to be considered. Each party then presents evidence, including testimony and arguments, and can cross-examine witnesses.

Unlike in mediation, where the parties themselves reach a consensus, the arbitrator renders a final and typically binding decision. Further, the rules in arbitration can limit damages, restrict the time limits for filing a claim and impede information sharing. Arbitration has one key limitation: an appeal is virtually impossible.

Taking a less costly route

Ideally, contractors can avoid disputes by engaging in clear and strong communication with project owners and everyone else involved in a job. However, if a disagreement rises to a certain level, mediation may hold the key to avoiding the costliest road to resolution. ■

Combating the skilled labor shortage

Even before COVID-19, construction companies were facing a shortage of skilled workers. The pandemic has only exacerbated the problem for contractors and many other types of businesses for that matter.

According to the *2021 Construction Outlook National Survey* by the Associated General Contractors of America (AGC), 54% of contractors are having a hard time filling some or all salaried and hourly craft positions. That's down from 81% in the 2020 survey, but it's still a significant issue. In addition, 49% of respondents to the 2021 survey expected hiring to be as hard or harder in the coming months.

The labor shortage doesn't just make it harder to handle current and future projects. It also creates safety issues. According to the 2021 AGC survey, contractors' biggest challenge regarding worker safety and health is "inexperienced skilled labor/workforce shortage," named by 59% of respondents.

There isn't one right strategy for solving the problem. Construction companies need to get creative. Here are some ideas for combating the skilled labor shortage:

Hire interns or apprentices. Partner with local high schools, community colleges or trade schools to establish internship, apprenticeship and skills certification programs. These programs can be attractive to students — especially if they offer the prospect of a guaranteed hire.

Go digital. Traditional hiring techniques are no longer enough. Take advantage of social media, online job boards and other digital solutions.

Younger prospects are far more likely to conduct a job search online, and the Internet makes it easy to expand the search beyond your geographical market. Skilled workers in other parts of the state or country, where jobs are harder to come by, may be willing to relocate to secure a quality job with a reputable business.

Take advantage of job-site technology. Recent advances in construction technology enable contractors to do more with fewer people. For example, drones can be used for site surveys, job monitoring and inspections. Construction robotics can perform tasks such as building walls or running equipment or vehicles without the need for an operator.

Also look into robotic process automation (RPA) software. It automates certain repetitive tasks — such as creating invoices, generating estimates, processing vendor invoices and managing documents. In turn, this can lower labor costs, reduce errors and free up workers for more critical activities. RPA can even be used to respond to certain inquiries from customers or prospects.

When used properly, these technologies enhance efficiency and productivity. In addition, they reduce risk; for instance, using drones or robots instead of workers to perform dangerous tasks. They also offer a recruiting advantage: Adopting

these tools creates a more tech-savvy culture that's attractive to younger workers who wish to learn about and use cutting-edge technologies.

Strengthen your "employer brand." A company should have a brand that inspires trust and is easy for customers to recognize. So too must an employer have a brand when it comes to appealing to job seekers.

To distinguish yourself from the competition, offer workers value beyond compensation. Examples include vacation and other paid time off, training programs, opportunities for greater work-life balance, and a clear career path. Hiring has been historically difficult for most employers recently. Strengthening your employer brand will give you a fighting chance. ■

Pump up tax savings with the fuel credit

Construction companies that wish to reduce their tax bills or increase their refunds shouldn't overlook the fuel tax credit.

The federal fuel tax, which is used to fund highway and road maintenance programs, is collected from buyers of gasoline, undyed diesel fuel and undyed kerosene. (Dyed fuels, which are limited to off-road use, are exempt from the tax.)

Purchasers of taxable fuel often use it for nontaxable purposes. For example, construction businesses often use gasoline, undyed diesel fuel or undyed kerosene to run off-road vehicles and construction equipment, such as front loaders, bulldozers, cranes, power saws, air compressors, generators and heaters.

The only way for a contractor to recoup taxes paid on nontaxable fuel use is to claim the fuel tax credit.

How much can you save?

Currently, the federal tax on gasoline is $0.184 per gallon and the federal tax on diesel fuel and kerosene is $0.244 per gallon. Calculating the fuel tax credit is simply a matter of multiplying the number of gallons used for nontaxable purposes during the year times the applicable rate.

Keep in mind that fuel tax credits are includable in your company's taxable income.

So, for instance, a construction company that uses 7,500 gallons of gasoline and 15,000 gallons of undyed diesel fuel to operate off-road vehicles and equipment is entitled to a $5,040 credit (7,500 x $0.184) + (15,000 x $0.244).

This may not seem like a large number, but it can add up over the years. And remember, a tax credit reduces your tax liability dollar for dollar. That's much more valuable than a deduction, which reduces only your taxable income.

Keep in mind, though, that fuel tax credits are includable in your company's taxable income. That's because the full amount of the fuel purchases was previously deducted as business expenses, and you can't claim a deduction and a credit on the same expense.

How do you claim it?

You can claim the credit by filing Form 4136, "Credit for Federal Tax Paid on Fuels," with your tax return. If you don't want to wait until the end of the year to recoup fuel taxes, you can file Form 8849, "Claim for Refund of Excise Taxes," to obtain periodic refunds.

Alternatively, if your construction business files Form 720, "Quarterly Federal Excise Tax Return," you can claim fuel tax credits against your excise tax liability.

Why pay if you don't have to?

No one likes to pay taxes they don't owe, but if you forgo fuel tax credits that's exactly what you're doing. Given the minimal burden involved in claiming these credits — it's just a matter of tracking your nontaxable fuel uses and filing a form — there's really no reason not to do so. ■

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. ©2022

Gelman LLP
Certified Public Accountants
& Business Advisors

1 Park Plaza STE 950
Irvine, CA 92614
Phone 714-667-2600
Fax 714-667-2636
www.gelmanllp.com

Think of us as your Personal Trainer

Winning in the construction business requires the same focus, drive and skill as coming out on top in sports. To compete effectively, you continually need to improve your game. And that's where Gelman LLP comes in.

We serve as your personal business coach and trainer, always looking for ways to help you become more competitive and successful. Our construction industry experts can show you how to reduce costs, increase productivity and bring more of your revenue to the bottom line.

As an accounting and consulting firm specializing in the construction industry for over 30 years, we offer a wide range of services designed to help you get and stay ahead of the competition. Our specialties include:

- Accounting and auditing
- Tax planning and reporting
- Bonding and financing
- Recruiting services
- Financial services
- Management consulting
- Strategic planning
- Computer systems consulting
- Network installation and support
- Software sales and support
- Succession and estate planning
- Litigation support
- Employee Stock Ownership Plans (ESOPs)
- Captive insurance

Our highly qualified staff focuses on serving closely held entrepreneurial businesses like yours. Our firm also offers insurance, financial and placement services through affiliations, offering you one-stop shopping for the professional services you need to stay on top of your game.

We would welcome the opportunity to answer any questions you may have about the topics discussed or others affecting your business. Please contact us at 714-667-2600 or info@gelmanllp.com and let us know how we can put our construction industry expertise to work for you.