Finance for the "Nonfinancial" Manager – 10 Things to Know

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Industry Overview & Trends

1. Construction industry:
   a. 3rd largest segment of World economy
   b. 2nd largest employer
   c. 2nd highest failure rate
2. The construction industry has recovered in most regions and types of work
   a. Some contractors had their best years ever in 2015-17
   b. Historically (1945-1990) recoveries lasted an average of five years.
   c. 1992-2008 broke the 5-year cycle trend.
   d. We are over 9 years into the current expansion

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Industry Overview & Trends

3. Bid prices are still tight and low in certain markets and niches
   a. GC fees are too low for certain sectors – 2% to 3% stated fees
   b. Large bid lists in certain areas and niches
   c. Heavy highway, infrastructure, education, healthcare, office, warehouse, manufacturing, etc. are good
   d. Retail, church/religions and home building (in certain areas) are flat
   e. Residential – when will it end?
4. The increase in work has strained cash flow – some contractors are still struggling with growth
   a. Many GCs are thinly capitalized
   b. Debt levels are high for both developers and some contractors

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Industry Overview & Trends

5. Construction Trends:
   a. More self-performed work
   b. Increase in “strategic” mergers and acquisitions
   c. Technology – jobsite field reporting, vehicle tracking
   d. More focus on internal controls – cost controls, labor, change orders, etc.

6. Financial:
   a. Surety bond market still favors the contractor.
   b. Bank regulation is much tighter. Many banks don’t understand construction. Strict covenants are requested even for good customers.

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Industry Overview & Trends

7. Who will be the next generation of contractors?:
   a. Average age of a first-line construction supervisor is currently 51 years old.
   b. 23% growth anticipated in the number of subcontractor trade jobs over the next 10 years.
   c. Ability to attract and retain millennials.
      - The average millennial graduating today expects to have 14 jobs over his/her career.
   d. Succession planning is a major concern.

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Industry Overview & Trends

8. Other hot trends and issues in the construction industry:
   a. Increase in strategic merger and acquisition activity
      - Still a buyer's market – values are not up significantly
      - Needed consolidation of smaller entities and markets
      - Financial or people issues at "target" company
   b. Technology
      - Field reporting – labor and equipment
      - GPS and cameras
      - Payroll
   c. Employee incentive and retention plans
      - Newco and phantom stock
      - Job budget bonuses

10 Things You Need to Know about Construction Accounting and Tax

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10 Things You Need to Know

1. Construction industry accounting and taxation are unique.
   a. Both the CPA and the contractor's controller must have education and experience with contractors.
2. You need to understand construction accounting
   a. Percentage of completion method
   b. Job costing principles – job costs versus overhead
   c. Unique financial reporting and disclosure requirements
3. Estimation of gross profit and percent complete is the essential component of financial reporting for a contractor.
   a. Net income, working capital, and equity are all derived from those estimates.

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10 Things You Need to Know

4. Tax reporting and financial revenue recognition methods should *always* be different.
5. Understand Construction Taxation:
   a. Available methods:
      - Cash
      - Accrual / Accrual excluding retainage
      - Completed contract method (long-term contracts)
      - Percentage of completion (long-term contracts)
      - Contracts that extend over a fiscal year-end are long-term.
      - Covers improvements to real property (not service work)

   b. Depreciation methods; repair capitalization

   c. Multi-state taxation
      - (sales tax, gross receipts tax, payroll tax)

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10 Things You Need to Know

6. Understand the Importance of Cash:
   a. Billing cycle management
   b. Stored materials clauses
   c. Retainage reduction and/or substitution clauses
   d. Cash management is NOT holding subcontractor’s or supplier’s money
   e. Create incentives for PMs to improve contract cash position
   f. Convert contract schedules to cash basis
   g. Prepare backlog cash flow schedule

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10 Things You Need to Know

7. Working Capital is the most important contractor ratio:
   a. Current Assets less Current Liabilities
   b. Working capital is the primary basis for surety credit
   c. Tangible working capital is working capital reduced by prepaid expenses, 50% of inventories, underbillings, related party receivables and similar “soft” assets)
   d. Tangible working capital should equal at least 7.5% of annual revenue

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10 Things You Need to Know

8. Other important contractor ratios:
   a. Cash greater than 5% of annual revenue (non-borrowed cash)
   b. Line of credit great of at least 5% of annual revenue
   c. Tangible equity greater than 15% of annual revenue
   d. No underbillings (POC construction revenue in excess of amounts billed)
   e. Overbillings of at least 2% of annual revenue (covers warranty, finishing, etc.)
   f. No bad debts or old receivables over 90 days past due
   g. No significant job fade (estimated vs. actual profit)
   h. Interest debt of less than 50% of equity

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10 Things You Need to Know

9. BAD contractor ratios:
   a. Net underbillings – underbillings in excess of overbillings ("phantom asset")
   b. Underbillings greater than 10% of equity
   c. Old receivables over 90 days – greater than 5% of equity – non-bonded private owners with no certificate of project financing
   d. Claims, unapproved change orders or other contract litigation
   e. Inventories greater than 20% of annual purchases
   f. Interest debt greater than 100% of equity (including non-cancelable leases)
   g. Total liabilities greater than 300% of equity
   h. Soft assets such as goodwill, loans and investments in non-business assets – greater than 10% of equity
   i. More than 10% of equity in stock market investments
   j. Significant bid spreads (greater than 3%)

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10 Things You Need to Know

10. Know the components of job cost and use them in estimating and forecasting:
    a. Labor costs
    b. Labor burden
        - Payroll taxes
        - Vacation / Holiday / Sick
        - Payroll insurance: Health, life, dental, etc.
        - Employee Screening
        - Training and safety labor and meetings
    c. Subcontractors
    d. Installed materials
    e. Equipment costs
    f. Indirect costs (allocate based on labor or similar basis)
        - Other job site insurance: Worker comp, general liability
        - Auto expense
        - Small tools

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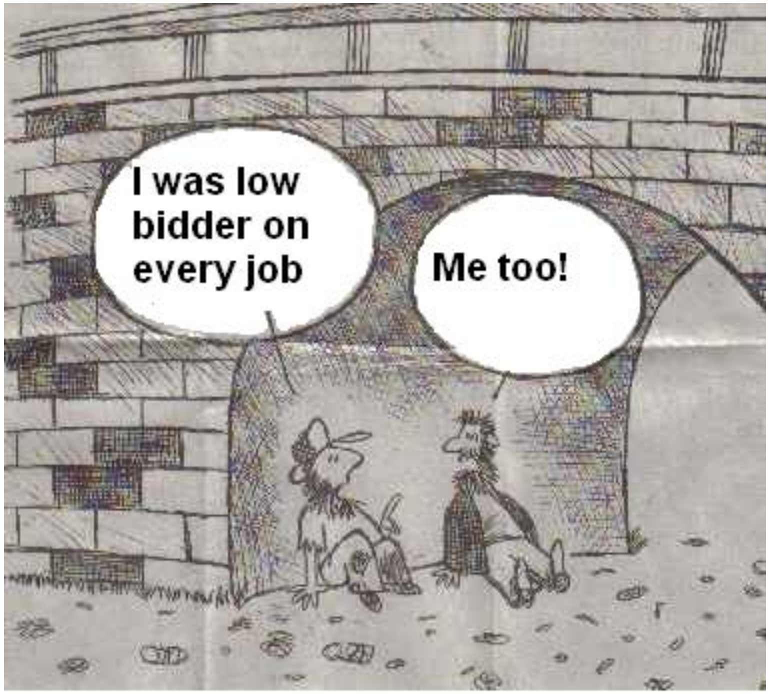
What Causes a Contractor's Business to Fail?



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Most Common Causes of Contractor Failures

1. Inadequate working capital / cash flows
   a. Spending overbillings
   b. Not allowing for costs to complete
2. Owner failure to pay
3. Unresolved disputes with owners – unapproved change orders, unresolved claims
4. Failure to recognize or respond to problems in a timely manner
   a. Usually due to poor budgeting or job costing systems
5. Subcontractor failure

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Important Internal Control Reminders

"Oh, that three billion dollars."

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Important Internal Controls

1. Obtain background and credit report on new employees
   a. Especially if employee relocated from another State
   b. Employee knowledge and signature required
   c. Approximate cost is $300; "FBI type" report cost is $2,000
2. Bank statements and canceled checks should be reviewed monthly by owner or management personnel independent of check preparation and signing process:
   a. Altered checks – payee and/or amount
   b. Electronic transfers and inter-company transfers
   c. Forged or unauthorized check signatures
   d. Unusual payee and/or endorsement
   e. Signs of altered payee or amount
   f. Duplicate checks to same payee and same amount
   g. Create a fear that you will review every check

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Important Internal Controls

3. Check signing process is important – electronic or manual
   a. Dual signatures are recommended; Accounting personnel with access to check disbursement process should never sign
   b. CFO should be locked out of check preparation if a signer
   c. Sign checks manually (not electronically or with a stamp)
   d. Signer (or final check reviewer) must have documentation as check is signed. Information should be spot-checked for authenticity and approval procedures. Signing a "stack" of checks is bad.
   e. Scanners have created a whole new world for fraud – concern for duplicate payment of scanned invoices – and alteration. System should protect against altered vendor invoice numbers to avoid duplicate payment.
   f. Meet with bank to develop separation of duties and controls for ACH and cash transfers
   g. Emergency checks should be scrutinized carefully. Avoid "manual" checks that are not produced in the computer
   h. All contractors should use "positive pay" system

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Important Internal Controls

4. Cash receipts and deposits function
    a. Controller or A/R clerk should never pick up mail or make bank deposit. Never. Anyone with access to billing and accounts receivable cannot handle incoming checks
    b. Lock box and electronic payment should be used if practical
    c. Mail clerk should prepare a manual deposit log. Logs should be protected from destruction or tampering. Logs should be used to verify deposit accuracy. Checks should be copied.
    d. Check scanning deposit process (if utilized) should be performed by person independent of A/R or Billing.
    e. Review aged receivable list monthly
    f. Perform a proof of cash reconciliation at least once per year. Compare total deposits with total credits in A/R
    g. Billing and A/R clerks must be “locked out” of journal entries to credit Customer A/R

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Important Internal Controls

5. Labor Controls

a. Daily times sheets are mandatory – prevent 10-10-10 phenomenon
b. Occasionally perform a surprise payroll check off. Deliver checks to job site and personally hand out checks. Investigate “missing” employees.
c. Use direct deposit or smart cards instead of payroll checks
d. Consider bonus based on labor budget savings
e. Review canceled payroll checks returned with bank statement
f. Someone independent of payroll clerk should trace electronic tax deposits on tax returns
g. Utilize E-Verify system properly – no exceptions
h. Payroll clerk should be “locked out” of creating new employee or changing rates without HR approval process (separation of duties)
i. Comply with retirement plan timely deposit rules

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Vehicle Controls

1. Use GPS tracking for Company-owned vehicles:
    a. Excess speed
    b. After-hours usage
    c. Down time
    d. Off jobsite usage
    e. Insurance savings – direct and indirect

2. IRS closely monitors tax treatment of Company-owned vehicles:
    a. Personal usage by employee (including commute) is <u>always</u> examined in an IRS audit.
    b. Personal usage should be reported on W-2

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Vehicle Controls

3. Policies for employee-owned vehicles:
   a. Insurance coverage
   b. Good and safe vehicles
   c. Mileage reporting is mandatory. Mandatory IRS mileage rates (with and without fuel)
   d. Vehicle allowances are generally taxable to the employee (and require employer payroll taxes) unless the employee keeps mileage logs
   e. See attached sample policies

Sample Vehicle Allowance Policy

Forehand Construction Company Responsibilities

1. Operate the plan under IRS rules and regulations which allow for the non-taxable treatment of vehicle reimbursements for participants who comply with monthly business mileage reporting requirements. The total annual vehicle allowance must not exceed the business mileage submitted for the full year at the applicable IRS reimbursement rate. (Currently 54.5¢ per mile. If gas card provided, non-taxable mileage is limited to 40¢ per mile)
2. Pay the employee a fixed monthly vehicle allowance amount of $________ on or before the 5th day of each month via direct deposit or manual check
3. Provide a Company fuel credit card to the employee which will require input of the vehicle odometer reading at the time of purchase. Fuel purchases are allowable for the designated business vehicle only. Employee will be required to reimburse the Company for fuel charges in excess of reasonable mpg calculation.
4. Include any taxable income on the employee's annual Form W-2 for any amounts paid in excess of IRS non-taxable calculation.

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Sample Vehicle Allowance Policy – Continued

Employee Responsibilities:

1. Provide proof of insurance with an A-rated company demonstrating minimum coverage limits of $300,000/$300,000/$100,000. An insurance card stipulating the limits must be submitted to the Davidson Construction risk manager with an expiration date of not less than 6 months. Consider adding company as "named insured" with insurance carrier to receive direct notice of extension or cancellation.
2. Vehicles must not be older than 5 model years and must meet minimum standards for safety and operating condition. Tires, brakes, lights and similar items must be in good operating condition. The vehicle must be a ½ ton or larger pickup truck with undamaged body and appropriate exterior paint color. No bumper stickers or controversial/political messaging will be allowed on the vehicle.
3. Monthly mileage reports detailing daily jobsite and other business travel must be submitted by the 1st day of each month to receive payment. The preferred procedure is to e-mail the mileage report to Human Resources on the Excel template provided. Allowance payments will be withheld if insurance cards are not on file or mileage is not submitted by the 1st of each month.
4. Employee must adhere to drug and alcohol policies included in the employee handbook at all times while operating the vehicle.

I have thoroughly read and understand the Forehand Construction vehicle allowance policy.

Employee ___________________________________

Date_______________________________

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Whit Forehand is Managing Partner of Forehand & Associates, which is a full-service accounting focusing exclusively on the construction industry and related enterprises. Whit has 30 years of accounting experience, focusing exclusively on construction and related issues since 1993. His specific areas of focus include financial statement analysis, surety bonding issues, claim documentation and consultation, accounting-related litigation support, and merger and acquisition consultation.

Whit has written and spoken extensively on construction accounting issues, and is the author of over 20 articles on construction accounting. Whit serves on the editorial board of the Journal of Construction Accounting and Taxation. Whit serves as a Subject Matter Expert for CFMA publications, and is the author of two chapters of the Construction Controller's Manual published by RIA Thomson Reuters. Whit is a frequent speaker on construction accounting topics and served on the AICPA National Construction Committee from 2014 to 2017.

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