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CONSTRUCTION INDUSTRY ADVISOR

Soggy numbers
6 common accounting mistakes to avoid

Third-party funding helps contractors pursue claims

Help yourself and the environment with recycled materials

Looking for skilled workers in all the right places

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Soggy numbers

6 common accounting mistakes to avoid

You're probably familiar with the term "crunch the numbers." Well, in a tumultuous industry like construction, it's all too easy to let crisp, timely financials go soggy with outdated data and flat-out mistakes. Here are six common accounting errors to avoid.

1. Inaccurate allocation of overhead

To develop a realistic picture of your job costs — and, therefore, the profitability of your projects — you need reliable methods for allocating overhead among jobs. Overhead generally refers to costs that benefit all jobs. Examples include rent, office equipment and supplies, salaries for executives and clerical staff, insurance, taxes, advertising and marketing expenses, and accounting and legal fees.

Construction companies often allocate overhead among jobs based on direct labor costs or direct labor hours. But, in some cases, this approach causes over- or underallocation of overhead, which creates a distorted picture of job profitability.

For example, if your projects tend to be equipment or material intensive, rather than labor intensive, it may make sense to allocate overhead based on one of those costs or perhaps some blend of direct job costs. The key is to develop a method for allocating overhead costs to the jobs that drive them.

2. Improper cutoff of job costs

Many construction businesses use the accrual basis of accounting, which means they record revenues when earned and expenses when incurred. Cutoff errors occur when expenses are omitted from a period covered by a financial statement — typically, because invoices aren't received until after the period is closed.

Are you susceptible to this problem? If so, consider implementing a voucher system or some other mechanism to ensure costs are recorded as liabilities or accrued costs in the period in which they're incurred.

3. Erroneous change orders

Change orders represent both great opportunities and potential pitfalls for contractors. What's more, the accounting rules for dealing with them are complex and can lead to errors.

For instance, if you're overly optimistic that a change order will lead to additional revenue, you may overestimate profits — resulting in profit fade as the job progresses. This may happen if you begin out-of-scope work before the change order is approved, or if you and the owner agree on scope but leave discussions of price for another day.

4. Inaccurate job cost estimates

For contractors that use the percentage-of-completion (POC) method to account for jobs, estimated job costs is a key factor driving revenue recognition. Errors may be caused by:

- Poor estimating or forecasting,
- Inaccurate recording of actual costs, or
- Mishandling of change order accounting.

Among the best ways to avoid the effects of estimating errors is to reconcile actual to estimated costs on a monthly basis.

5. Failure to recognize loss contracts

Construction companies that use the POC method sometimes fail to consider whether a job is likely to generate a loss. Under such circumstances, Generally Accepted Accounting Principles require them to fully recognize the loss at the time it's determined.

If you've encountered this issue in the past, be sure to stay informed. Regularly review each project's job cost schedule. In the event estimated costs exceed the contract amount, be prepared to accrue a loss.

6. Improper treatment of joint ventures

Joint ventures, like change orders, are potentially valuable opportunities that come with their own accounting rules. Without going into detail, the manner in which costs and profits are shared among the participants depends on the way in which the joint venture is structured and on the terms of their agreement.

To avoid errors, leave nothing to chance. Be sure you and the other party agree on the proper accounting treatment before starting work. From there, implement procedures to ensure that the venture's activities are properly documented.

Numbers matter

Construction is characterized by thin profit margins and a high degree of uncertainty. So accurate financial reporting is important not only to operating successfully, but also to looking good in the eyes of sureties, lenders and other stakeholders. And to make the challenge even greater, contractors should begin to prepare for new revenue recognition rules that take effect in 2018. (See "Accounting changes on the horizon" above.) ■

Accounting changes on the horizon

If your construction company follows Generally Accepted Accounting Principles (GAAP), important changes are ahead. A new accounting standard that rewrites the rules for revenue recognition is scheduled to take effect in 2018 for calendar-year private companies. It prescribes a five-step model for recognizing revenue:

1. Specify the contract.
2. Identify performance obligations.
3. Determine the transaction price.
4. Allocate the price among the performance obligations.
5. Recognize revenue when (or as) performance obligations are satisfied.

What does this mean for contractors? For one thing, a contract previously treated as a single performance obligation — such as one that calls for construction as well as equipment installation — may have to be accounted for as two separate performance obligations with different revenue recognition schedules.

Also, the new rules will eliminate the percentage-of-completion method of accounting for long-term contracts. This doesn't mean you won't be able to recognize revenue gradually over a project's life. But, for that to happen, you must gradually cede control to the owner. Whether you'll be able to do so will depend on various factors, including the nature of the job and contract terms.

Between now and the end of 2017, you'd be well advised to evaluate how the new standard will impact your construction company. You may need to consider contractual or other changes to ensure compliance with GAAP. Your CPA can help you get ready.

Third-party funding helps contractors pursue claims

Like it or not, disputes are an inevitable part of the construction process. Unfortunately, to avoid the high cost of litigation, many contractors fail to pursue even strong claims or settle for far less than they deserve. An increasingly popular option that may help with this dilemma is third-party funding of construction disputes.

How does it work?

Third-party funding involves engaging an outside party (that is, one without a current interest in the dispute) to finance some or all of a claimant's legal costs in exchange for a portion of any recovery. Essentially, it's a nonrecourse loan secured by the claimant's rights to any judgment, arbitration award or settlement. "Nonrecourse" means that, if the claimant is unsuccessful, the third party receives nothing.

Such arrangements are also available for defendants, who pay a premium to the funder in the event their defense is successful. With these arrangements, it's critical for the parties to agree upfront on what constitutes a successful result. For example, it might mean dismissal of the claim or settlement below a specified amount.

Not all claims are suitable for third-party funding. Typically, they're limited to commercial, rather than individual, disputes. And litigation funding firms generally won't get involved with claims that have a low probability of success or are expected to drag on for extended periods of time, increasing their expense and risk.

Funders will also evaluate other factors. They'll assess the quality of the law firm representing the claimant, and examine the defendant's financial strength to gauge the likelihood that any judgment or settlement will be collectible.

What are the benefits and risks?

The most obvious benefit of third-party funding is that it enables parties to bring claims that they would otherwise lack the resources to pursue. But the benefits may go further than that.

Because the financing is nonrecourse, third-party funding shifts some or all of the risks associated with litigation or arbitration from the contractor or other party to the funding firm, which is better equipped to bear that risk. Another benefit of nonrecourse financing is that it may allow a claimant to keep litigation expenses off his or her financial statements, making it easier to continue operating while a dispute is pending. Contractors who finance claims themselves may find that significant litigation expenses hurt their ability to secure loans or surety bonds.

Third-party funding may also be available for claims that have been settled but not yet paid. For instance, they may allow a contractor to convert pending settlement funds into cash they can use to finance ongoing business operations.

As you can see, third-party funding offers a variety of benefits. But they come at a hefty price. Third-party funders assume a great deal of risk, and they expect to enjoy returns that are commensurate

with that risk when claims are successful. It's not unusual, for example, for a funder to receive 40% of the proceeds. Add in contingent attorneys' fees and the percentage left for the claimant is relatively modest.

Is it right for you?

If you're contemplating third-party funding, be sure that you understand the payment terms and weigh the costs against the potential benefits. Your CPA can help you calculate a cost vs. benefit analysis. ■

Help yourself and the environment with recycled materials

Using recycled and reclaimed materials for construction projects can help curb greenhouse gas emissions and other pollutants. Doing so can also reduce the amount of waste sent to landfills.

But, while doing good is its own reward, construction companies that use or produce these materials can also enjoy a variety of financial benefits. These include spending less on materials, reducing disposal costs, and even bringing in revenue from the resale of reclaimed building materials or components.

C&D sites

Construction and demolition (C&D) sites are great sources of recycled building materials. These locations are typically run by architectural salvage dealers, demolition contractors, C&D haulers, recycling companies and other entities.

Items found at C&D sites are generally cheaper than "virgin" material, and they may have "vintage" qualities that appeal to certain customers. Examples include:

- Doors and windows,
- Lighting and bathroom fixtures,
- Pipes and fittings,
- Appliances, and
- Vintage items such as hand-carved fireplaces or antique doorknobs.

In addition, it may be possible to recycle beams and other structural components, crush masonry for use in sidewalks or road bases or melt down scrap metal for reuse.

C&D sites can also be places to *leave* materials and walk away with a little extra revenue. For example, instead of simply demolishing a building, you might develop a "deconstruction" plan designed to preserve materials for reuse or resale. Following such a plan can reduce your hauling and disposal costs, too.

Byproducts for building

Too often, the byproducts of industrial processes are disposed of as waste even though they may be valuable sources of relatively inexpensive building materials. Consider fly ash, a byproduct of coal-burning power plants. It can be a cost-effective and environmentally friendly replacement for Portland cement in producing concrete. It can also be used to make cultured stone, carpet backing, flooring tile and tile underlayment.

Similarly, air-cooled blast furnace slag can help produce mineral or rock wool insulation. And spent foundry sand can be deployed as base material for building sites. Those used tires you're pulling off vehicles and equipment? They can be recycled for rubberized walkways, carpet backing or foundation support.

These materials not only reduce costs, but in some cases also offer performance advantages. For instance, fly ash can improve the performance of concrete. And spent foundry sand can extend the construction season in colder climates because it doesn't freeze as readily as most natural soils.

Recycled or reused materials not only reduce costs, but in some cases also offer performance advantages.

Potential advantages

As your construction company forges ahead into the new year, consider the potential advantages of recycled and reclaimed building materials. Just be sure to check any items salvaged for lead paint or other toxic substances that may render them unusable. ■

Looking for skilled workers in all the right places

The problem isn't going away. The construction industry has long faced a shortage of skilled labor. One might hope a new year would bring good news, but statistics and general sentiment indicate that there will be no breakthrough anytime soon.

Construction businesses currently employ 1.6 million fewer workers than they did in 2007, according to a spokesperson for the American Institute of Architects late last year. And a relatively low industry unemployment rate means there are few available hires. Despite all of the doom and gloom, however, you can still find skilled workers — or create new ones — by looking in the right places.

Look to veterans

If you need skilled labor immediately, it may be time to look beyond your usual hiring pool. One option to consider is veterans. Many are trained in construction-related skills and have worked on building and engineering projects.

From a tax perspective, veterans are also an intriguing choice because of the Work Opportunity credit. This tax break benefits employers that hire individuals who are members of a "target group," one of which is military veterans. The maximum tax credit that can be earned for each member of a target group is generally

$2,400 per adult employee. But the credit can be as high as $9,600 per qualified veteran.

As you might expect, a variety of rules and restrictions apply. Work with your CPA to determine whether and how to qualify for the credit.

Hire more widely

Also consider looking into additional labor networks you may not have previously fully tapped. For example, as recently as 2014, women made up only about 9% of U.S. construction workers, according to the Bureau of Labor Statistics. But there remains a strong push within the industry to get more women involved. If you do hire from this group, you may want to add or enhance the sexual harassment prevention components of your employee orientation and training program.

Another potential source of skilled labor is your competition. Keep an eye on what other local construction companies might be changing specialties or closing up shop. Obviously, hiring away employees could rub these industry colleagues the wrong way. So be sure to execute this strategy carefully and ethically.

Work smarter

There are a variety of project-management strategies for dealing with a skilled labor shortage. Look into spreading out jobs over longer periods to more easily and evenly distribute skilled labor. Many contractors are also taking a keen interest in integrated project delivery, which is a more collaborative approach that actively seeks to maximize project efficiency — including labor usage.

In addition, if you're losing skilled laborers or having a hard time hiring, review whether your compensation rates and benefit plans are as competitive as possible. You can use benchmarking data to compare your offerings to those of similar companies.

Fix the future

Looking at the long term, construction company owners should consider themselves ambassadors for the industry. This means:

- Emphasizing customer service,
- Running clean, minimally disruptive job sites, and
- Minimizing your carbon footprint.

Positive publicity is also important. Getting involved in social media not only can promote your company's services, but also can attract quality employees. Publicizing notable projects with your local print, radio and television media can let the best and brightest skilled laborers in the area know what you do, too. Put (or keep) industry events such as trade shows on your agenda, as well.

In the long term, contractors interested in nurturing tomorrow's workforce need to get involved in educational outreach. This means starting high school kids in classes and internships that spark their interest in the construction trades. From there, mentorship programs can set them on track for fulfilling careers.

Exercise optimism

It's easy to get down about the skilled labor shortage. But just because this problem has been persistent doesn't mean it's unsolvable. As you continue to build your construction company's success, you've also got to invest in the success of the industry itself. ■

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CPAs & BUSINESS ADVISORS

111 Veterans Memorial Blvd, Suite 600 | Metairie, LA 70005-3057
504.835.5522 | FAX 504.835.5535

Does your employee benefit plan need an audit?

With the end of 2016 fast approaching, now is the right time for companies to assess whether or not their Employee Benefit Plans (EBPs) are approaching the 100-plus participant threshold. If those EBPs do, in fact, meet this criterion by the first day of the plan's year, the plan's company sponsor is generally required – by the Employee Retirement Security Act of 1974 – to have a financial statement audit by an independent certified public accountant. This is part of the sponsor's obligation in filing its Form 5500. The audits are important, as they provide an independent, third-party opinion regarding the EBP's future ability to pay benefits and other financial obligations promised to participants. The information is shared with the participants, plan management and the Department of Labor. Still, many employers are not aware of this requirement and the importance of contacting an independent auditor in a timely manner, usually resulting in future headaches and penalties.

Employee benefit plans have been under a regulatory microscope recently and investigations and audits have been increasingly successful at identifying and penalizing plan administrators – up to $1,100 per day – for failure to meet their fiduciary responsibilities. Plan administrators who view the audit simply as a commodity and select a firm based not on qualifications, but on the lowest fee, may run the risk of paying even more through substantive penalties.

The LaPorte Employee Benefit Plan Services Group audits more than 60 employee benefit plans each year. These plans have anywhere from 100 to 7,000-plus participants, and assets ranging from less than $1 million to more than $125 million. Through continuing professional education, LaPorte team members are up-to-date on regulatory and legislative developments. LaPorte is a member of the American Institute of Certified Public Accountants' Employee Benefit Plan Audit Quality Center, demonstrating its commitment to and understanding of the employee benefit plan industry. In short, LaPorte has the experience and resources required for a quality EBP audit.

We would appreciate the opportunity to meet with you and discuss the importance of having the right firm for your plan – and to demonstrate why we believe that the right firm for you is LaPorte. Learn more or let us answer your questions, by contacting Tracy Tufts at 504-838-4854 or at ttufts@laporte.com.