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WHAT'S INSIDE

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Construction

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A Newsletter for the Construction Industry SPRING 2009

Can You Hold Out Until Recovery?

Being Surety-Friendly, Today and Tomorrow

Recovery in the construction industry will come, and not so far down the road. The financial collapse, automotive catastrophe, and widespread layoffs, on top of the housing disaster, are leading to broad government intervention. Tax cuts and massive spending are about to take place, and many billions of these dollars will go fairly quickly into "shovel-ready" construction projects.

The contracting pool, meanwhile, will shrink as some contractors fold. Of those that remain for a share of the new work, most will put their companies back on track to profitability. But some — especially those badly weakened by the downturn — will fail because they can't qualify for bonding.

Take the example of Four Corners Framing and Carpentry. They barely held on through the recession, but now they'll have a chance. The turnaround for them will be the government-funded Shoals Project, which would allow the company to put on ten crews.

But in the end, Four Corners won't even bid the job. Why? Because it won't be able to arrange a surety bond. After soldiering through the downturn — winning the war, you might say — Four Corners is about to lose the peace.

A huge infusion of government cash into the construction business may loosen the underwriters somewhat. But don't expect surety confidence to reach pre-2001 levels again — two waves of construction defaults and the credit freeze have seen to that.

Meanwhile, more owners require bonding for more projects. Contractors who seek bonded work, today and tomorrow, must align their companies along surety-friendly lines. Not coincidentally, those are the same lines that help contractors weather recession storms. Here are three of the most important:

1. Bid for the job, not against your competition. Don't start with the "market," or what it will take to win the job. Rather, start with what you need to earn on the job and what it will cost you to complete it.

This seems obvious, but in lean times — and coming out of them — it's tempting to grab for any work at all. A take-any-job approach can weaken a company badly,

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Making an IRS Audit Less Painful

"The IRS has selected your company for audit." For the stress this statement can cause, the best antidote is well-kept books. The knowledge that every expense claimed is a business expense, fully documented, greatly reduces the discomfort of an audit. So does a confident approach to the audit itself. Here's a look at the process.

The Audit Letter Arrives

When the IRS selects a company for an audit, the agency notifies it with a letter, which includes a request for a meeting to review tax records for a specific year.

The letter sets out details — a meeting date, your rights in the audit (among them representation and reasonable schedules), contact information and so on. It also includes a list of documents the IRS wants to inspect, which could include financial statements, tax returns, depreciation schedules, payroll records or other material.

Review Your Records, Then Deliver

You and your advisors should review these documents carefully. You can't change the record, but you can familiarize yourself with it, especially the parts that concern the IRS's areas of interest. You may discover errors, gaps or other apparent oddities, and your accurate explanations for these will help avoid confusion or contention.

Next, organize the documents in an accessible format for the IRS. Your CPA can help you decide between digital files and hard copies. Provide everything requested but nothing more, and keep perfect copies.

Meet the IRS

The first meeting of the audit will take place at your office. You, your advisers and one or two IRS agents will become acquainted, review schedules and talk about your business. You'll be asked a standard set of questions — how is the company organized, what's the extent of owner involvement, and so on. The next step is to deliver the requested documents.

Set a good tone from the start. Treat your guests professionally, give them a brief tour of the office and answer their questions directly and fully. If you need to consult with employees or advisors, the auditors should accommodate that.

It's true that these professionals have the authority to dig into your business. But don't walk into an audit expecting a vendetta. To the auditors — if not to the audited — most audits are routine.

Auditor on Board!

The full audit may take weeks or even months, but generally an IRS auditor spends only a few days at the offices of the audited company or its representative. In either case, provide the auditor a comfortable, convenient and private place to work.

Scheduling the auditor's work at your CPA's site is less disruptive to your operations. Your CPA can answer most questions, consulting with you when necessary. Your privacy is important, too — an audit shouldn't be a hot seat for a business owner trying to run a company.

The auditor can make follow-up requests at any time, which usually take the form of an information document request, or IDR. Normally the IRS will have selected one or more areas to focus on, based on its analysis of your company's tax return, and although the audit can look into other areas, it typically does not.

Consequences

An audit might find errors or reject one or another of your company's tax positions. Such negative decisions will require payments — taxes, penalties, interest or all three — and these could be significant.

But remember that very few audits result in catastrophe. A company that keeps its books in order should come through in good shape. ■

Our firm can guide you through the entire audit process to ensure the best possible outcome. For more information contact Tom Murtagh at 630-545-4509.

What Currently Interests the IRS?

Tax trends come and go, and the IRS shifts its focus over time. Here are some current attention-getters:

- **Disproportion:** Outsized expenses always draw interest.
- **Domestic production deduction:** A contractor that claims this jobs-creation incentive should expect automatic scrutiny.
- **Cost accounting methods:** Contractors must match costs with revenue as the schedule progresses.
- **Capitalization of interest:** Interest on loans must be allocated along with other costs. And there's no small-business exception.

because repeated low-margin work leads to endless borrowing and debt repayment. Even when the recovery comes, a backlog of cheap work can prevent a contractor from taking on profitable jobs. Focus your bids on "fewer but better."

Also, unanticipated costs can easily turn a profitable job into a break-even one. That means taking a job at near-cost is asking for a loser out of the gate. Not many contractors can turn in great work at low margins. So it's better to bid jobs at true cost, plus profit. That means strengthening your estimating capability — and your field management's resolve to bill quickly and carefully.

2. Play to your strengths. When margins decline and competition increases, the grass in other pastures can look a lot greener. But taking a company into a new craft, or even a new subcraft, is difficult enough in good times. In lean times it can be the fastest way to lose money.

The same goes for new geography. Reaching far afield for work brings its own risks, among them hemorrhaging expenses and labor pools that may prove less reliable than the chamber of commerce advertised. Neither of these moves is impossible, and one might be necessary to endure the recession. But don't take the decision lightly and be sure you understand the risks and ramifications going in.

Decide in advance what kind of work offers your company a competitive advantage. Where can your expertise deliver the efficiencies that lead to profitability?

3. Streamline your cost structure. You've been doing that for years, right? But if there's any fat left, it has to go. Discussing this prospect with your lender and your surety can help identify unnecessary costs.

It's an economic fact: Sometimes laying off ten people can save a company, and failing to do so can doom it. Don't wait until you're almost under water, when panic and emotion are running high, to make contingency plans — review your workforce and identify the key employees who must remain. You may find you have options, too — shifting to a 30-hour week for a time has saved more than one contractor from having to lay off workers.

Put compensation issues squarely on the table. Delayed raises, reduced bonuses, tighter benefits schedules — and cuts to executive perks — can help get a company through. A healthy transparency can bolster morale, but only if sacrifices are shared.

"Bring overhead in line with the new realities. If volume and personnel are reduced, overhead must come down as well. But use a scalpel, not a cleaver. You don't want to undermine the quality work for which you've earned a reputation," says Vito Losi, partner-in-charge of the Construction and Real Estate Industry Group at Wolf & Company.

Push this approach down through the company. The better managers and employees understand the dire need for economy, the more they will find new efficiencies and drive out waste. ■

Our firm can help you manage the recession to come out the other side in fighting form and ready for a surety's inspection. For more information contact Vito Loisi at 630-545-4554.

Key Metrics for a Surety

NET INCOME TO CASH FLOW. Net income should be close to cash flows from operations. The latter equals income from jobs, minus costs, leaving out asset purchases.

WORKING CAPITAL. Divide assets by liabilities to find your current ratio. Most sureties look for 2-to-1 or higher (less for asset-heavy companies).

Net worth. How much can you afford to lose (so the surety won't)? Net worth, including liquidity, tells the story.

UNDERBILLINGS. When these approach 25 percent of working capital, a surety's alarm goes off.

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Construction Briefs

Look Back - You May Owe IRS Interest

What's hypothetical, complicated and required of most contractors? One answer: the Look-Back rules — an IRS method of making sure contractors aren't enjoying interest-free loans by virtue of their own estimating errors.

Look-Back applies to all construction companies who use the percentage-of-completion method (PCM) to report income for regular or alternative minimum tax purposes. A contractor uses its own cost estimates going into a project to calculate income from the contract in its first year, and it pays taxes on that income.

Of course, cost estimates rarely equal actual costs. So later — in the year the contract ends — the contractor uses actual costs, which are now known, to determine the contract's actual income and tax obligation. Then the contractor factors any first-year overpayment or underpayment into the later year's tax return, ultimately paying the correct tax on the contract.

If the contract profit in the first year was understated, the contractor had the use of the unpaid portion of the tax and now owes interest on it. The Look-Back rules require contractors to calculate this interest at U.S. government rates and pay it. A loan from the IRS is never free — even if the taxpayer was unaware a loan had been extended, and could only have avoided it by making perfect cost estimates in the first place.

On the other hand, a contractor who overpays using PCM is entitled to receive interest on the overpayment.

Some contracts are exempt from the Look-Back requirement — those for home construction, those in specified price ranges and those involving small contractors under certain conditions. ■

Look-Back rules for contractors are quite complex, but our firm can help you navigate them. For more information call Joel Dziedzic at 630-545-4508.