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# Construction

*Better Ways ▲ Better Results*

A NEWSLETTER FOR THE CONSTRUCTION INDUSTRY

WINTER 2010

## Surviving the Recovery When Business Picks Up, Cash Flow is Critical!



The timing and pace of economic recovery is still far from clear, but there are signs of cautious optimism. Ironically, this early stage of recovery can be the most perilous for a contractor.

After a prolonged downturn, it's natural to be eager to put crews back to work. Unfortunately, this can lead contractors who are already stretched financially to overextend themselves or take on risks they would normally avoid.

### Preparing for Expansion

As you gear up for greater volume, cash flow management — especially the prudent management of project start-up costs — is critical. In principle, there are two ways to approach this task:

1. Make an accurate forecast of your backlog. Then estimate the cash you will need to successfully manage the volume of work.
2. Determine your available cash and credit capabilities. Then estimate the volume of work you can safely handle.

In practice, of course, the process is more complex than this, and your approach will blend these two models. Ongoing changes in both backlog and your finances mean revisiting assumptions and estimates repeatedly.

In preparing cost forecasts, general contractors should pay special attention to those critical expenses that are not tied to "pay when paid" clauses that cause subcontractors to share some of the risk. Such costs include direct labor and bur-

# Act Now to Scoop Up Quality People



It may seem counterintuitive to consider hiring new people in the current economy, but now might actually be an ideal time to strengthen your team. Lack of business has probably forced many of your competitors to jettison some of their highest performers.

Before scooping up those talented employees, however, remember some fundamental principles:

**1) Be selective.** In addition to strong performers who were let go because

of the down economy, you can also expect to encounter underperformers, who were the first to be let go, as well as the overcompensated, whose high salaries made them visible targets for downsizing.

The key is to differentiate among these various types and approach only those you can afford — and who fit in with your company.

**2) Fill a specific, defined need.** Don't hire someone just because he or she is "too good to pass up." Have a job description and duties in mind. This is important for both financial and management reasons. High-performing employees are usually the type of people who will grow frustrated and bored if you can't keep them busy.

**3) Expect to train them.** Even the most experienced manager or administrator will need to learn your company's way of operating. Be prepared to commit the time and resources to bring them fully on board.

**4) Don't neglect your existing team.** Make sure you are keeping your best people challenged and rewarded. There's no advantage in hiring

talented newcomers if you end up losing your proven performers.

**5) Manage screening and interviewing efficiently.** It's easy to get overwhelmed by a flood of résumés. Hiring to fill a specific need can help you avoid unnecessary interviews that waste your time and the candidate's.

**6) Make a fair offer.** It can be tempting to underpay a new hire who is willing to take less, just to be employed. In the end, though, this "bargain" may end up costing you, as that talented but undercompensated employee moves on to greener pastures when the economy turns around.

Bear in mind that salary, bonuses and benefits are not the only factors. The most desirable employees also look for challenging and interesting work, useful training, and continuing career advancement opportunities. ■

*Recruiting talented people is just one of many challenges facing your business today. For more information contact Barry Shaw at 630-545-4515.*

## Accounting for Idle Equipment

When equipment sits unused for a long time, it's tempting to declare it idle. However, contractors should consider the following:

- For tax purposes, equipment is generally depreciated quickly in order to decrease taxable income. When depreciating for book value, however, most companies try to depreciate assets over their estimated useful life. Although this typically results in temporary timing differences between book and tax depreciation, slowing down book depreciation may result in a significant improvement to the company's book income. Higher

book income is always advantageous when applying for bonds or refinancing loans.

- When equipment is temporarily idle, the owner can continue to claim a tax deduction for depreciation and also continue to depreciate it for book. It may be appropriate, though, to slow down the rate of depreciation for book since the equipment's useful life may be extended while it is idle.
- On the other hand, an economic slowdown may decrease the demand for certain types of used equipment, which could nega-

tively impact the equipment's fair market value and offset the effects of slower depreciation.

Balancing these variables to evaluate the true fair market value of equipment is not easy, so you may need to obtain a qualified, third-party appraisal. But some subjectivity will still be required. Even experienced appraisers can arrive at different valuations for the same equipment.

Also keep property taxes in mind. In some states, idle equipment may not be subject to property taxes. An exemption is not automatic, so contractors should check local law.

den, equipment costs, fuel, supplies and, depending on the contract, some project materials.

The goal is a reliable and realistic forecast of upcoming cash requirements and revenue projections for the coming year or more. Don't let enthusiasm influence your judgment or lead you to assume everything will work perfectly. If you do, even a slight payment delay on one major project could lead to collapse.

### Maximizing Cash Flow

In addition to accurate forecasting, successful cash flow management also calls for other best practices, including prudently choosing which jobs to bid.

Vito Loisi, Partner, Wolf & Company LLP, says, "One of the most dangerous mistakes an eager contractor can make is to take on a project without ensuring that funding is in place. Contractors who fail to verify project financing can find themselves waiting for months for payment as they act as de facto interim financiers, a role few contractors can afford to take on." (See "Verify Project Funding," below.)

In addition to confirming financing, here are other steps that will help you manage cash flow.

- **Get off to the right start.** A good preliminary meeting with the owner or developer and the lender's representative can help prevent cash flow problems. Discuss in detail how you will be paid and what documentation will be required. Subcontractors should conduct a similar meeting with the general contractor.
- **Be prepared to negotiate.** Some lenders, sureties and owners are willing to negotiate certain issues such as the amount of retainage or lender set-asides. Don't be afraid to ask for an exception to standard practice.

- **Always invoice promptly.** Pay attention to the monthly billing cycle of your payment source. Missing a cut-off date by just one day could cause a 15- to 30-day delay in payment.
- **Manage change orders aggressively.** Contractors must be constantly alert to requests that are outside the original scope of work, and should process every change order promptly. Waiting until the end of the project greatly reduces your leverage.
- **Follow collections closely and protect your lien rights.** The deadline for filing a contractor's lien is set by statute. If you miss it, you no longer have a valid claim. Track

pending invoices carefully and, to avoid misunderstandings, alert the owners in advance that you file liens automatically whenever a deadline approaches.

- **Stay informed.** Contractors should pay attention to the status of other projects the owner or developer is building, and subcontractors should stay alert to the contractor's standing among the other trades. These can provide valuable early warning of a potential problem. ■

*Managing cash flow is crucial to your success. Our firm can help you develop and implement sound cash management practices. For more information, call Vito Loisi at 630-545-4554.*



## Verify Project Funding

Even the most carefully managed project can fail if the customer is unable to pay. How can a contractor ensure the owner's or developer's financing is solid? And how can subcontractors be sure the general contractor has the capital needed to keep the cash flowing? Here are three tips:

1. **Start with a thorough credit check.** Be particularly alert to past litigation, and any history of liens on older jobs. Your bank and bonding company can also be good sources of information. In addition to having access to excellent research sources, they may be willing to approach the owner's lender directly for updated project funding information.
2. **Check out the lender as well.** Public information and federal filings can alert you to any concerns about the project lender's financial health.
3. **Verify funding firsthand.** If possible, get permission to confirm the project's funding directly with the financing source. Ideally, the final contract should also provide for regular updates about the owner's financial condition.

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## Construction Briefs

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### Look Out for Unexpected Tax Obligations

After surviving the economic slowdown, now some contractors are facing higher-than-expected taxes.

Tax law revisions that benefited contractors in previous years may offer only limited relief this year, when the pace of business has slowed.

For example, one of the most popular tax breaks recently was the "Bonus Depreciation" provision, which allowed businesses to write off 50 percent of the cost of new major equipment purchases in the year of purchase, with the remaining 50 percent written off over the normal tax life of the asset.

This year, many contractors have added very little, if any, new equipment. Moreover, since the remaining value of the equipment on which they took accelerated depreciation in the past is now much smaller, their 2009 depreciation deduction may drop dramatically.

Unfortunately, the depreciation shown on the company's books for 2009 may be significantly greater than the allowable depreciation for tax purposes. This means it's possible to show a loss on the books but still incur an income tax obligation – a most unwelcome combination.

Another side effect of the slowdown is of particular concern to smaller

contractors, who often report revenue for tax purposes only when the job is complete, but use a "percentage of completion" calculation for book purposes. In most years, the practical effect of this is simply to postpone taxable income until the following year.

Now, however, with fewer open jobs, many contractors may find very little income left to defer. So while the income postponed from last year is now being reported, there is dramatically less deferrable income from current jobs to offset it. ■

*For more information call Joel Dziedzic, Partner at 630-545-4508.*