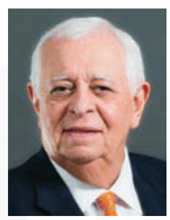
Feature

NASBP CPA Advisory Council Participants Share Insights on

Accounting, Tax, and Other Financial Issues

NASBP IS PLEASED to announce the new NASBP Certified Public Accountant Advisory Council (CPAAC). The CPAAC is comprised of certified public accountants with accounting, tax, other financial knowledge and experience in various relevant industries, including contract and commercial surety, construction, and government contracts. These distinguished CPAs who serve on the CPAAC comprise a valuable NASBP "resource team." They will provide articles for NASBP publications, including *Pipeline* and *Surety Bond Quarterly;* participate in NASBP Virtual Seminars; assist with the development of various online courses; and provide in-person presentations on various topics at the Annual Meeting, Regional Meetings, and special conferences and seminars.

As a brief introduction to this distinguished group, each has responded to a question posed on a current, compelling topic of interest to surety professionals.



Emilio F. Alverez
E.F. Alvarez & Company, P.A.
Miami, FL

Q What are some of the salient issues that get attention under the magnifying glass of a surety underwriter?

Answer: The number one issue is cash flow, and, consequently, anything that affects cash flow gets a lot of attention from surety underwriters. Underbillings affect cash flow in a negative way because they delay the moment of collection. Overbillings, on the other hand, bring in cash flow before the costs must be paid. However, if a contractor is overbilling and the money is not in the bank, the contractor is likely using the front-loaded money to pay for the costs of jobs that are either underbilled or losing money. Other issues related to cash flow are the relationship of receivables to payables; the contractor's debt load and its necessary debt service; the type of work the contractor is performing; and the kind of owner the contractor is working for.

The contractor's overhead also gets attention from surety underwriters. A company that is saddled with the type of general and administrative expenses that cannot be contracted or reduced and that signifies an inordinately high percentage of revenues will find it more difficult to become profitable than a contractor with low overhead, especially in a period of small gross profit margins.

A conservative attitude towards the recognition of revenue is always a trait welcomed by the sureties. That means the calculation of projected gross profit that is in keeping with the historical gross profit on the completed jobs. It means a sensible approach to the recognition of revenue on costs incurred performing unapproved change orders.

Jack Callahan
CohnReznick
Eatontown, NJ

Q What interaction should there be between surety bond producers and certified public accountants?

Answer: To thrive in today's competitive construction environment, contractors need to surround themselves with a core team of trusted advisors that can provide the insight needed to compel these contractors to ask, and have answers for, the really tough questions. The contractor's certified public accountant (CPA), surety bond producer, insurance agent (if not the bond producer), attorney, and banker should all specialize in working in the construction industry.

One critical step for the bond producer is to become familiar with the contractor's independent CPA and take the time to evaluate his or her knowledge of the construction industry. The CPA should be experienced in identifying critical financial statement issues related to the contractor's business. The contractor's financial statements must provide the detailed supplementary schedules that a surety company needs for underwriting. Additionally, in recognition of key independence and confidentiality issues, there should always be an open dialogue maintained between the CPA and the bond producer. This will help to ensure that all significant commitments and concerns are clearly communicated. With a core team of trusted advisors all communicating effectively, the contractor will most likely be in the best position to succeed.

Gehrig Cosgray
CliftonLarsonAllen, LLP
Calverton, MD

Q How often should a contractor address profit fade?

Answer: Profit fade analysis is a self-performance evaluation, and, consequently, a contractor often ignores a job's profit fade until it is too late to reverse the slide. Profit fade can occur for a number of reasons but typically is due to incomplete or overly optimistic estimated production or unit costs; underestimated labor or equipment rates; unbillable change orders or extra work; poor subcontractor performance; inadequate field supervision, resources, or training; and adverse weather conditions.

Adverse weather conditions are unavoidable; however, the other reasons can be addressed. Some best practices to assist management are the following:

- Review monthly job profitability reports and require an explanation for any job that is underbilled. Carrying inexplicable underbillings or believing that change orders will be approved despite continuing denial by the customer will often result in abrupt profit fade at the end of the project.
- Require management approval of work performed without an executed change order.
- Engage project managers in the process, as they will or should be the first to become aware of a profit fade and are in the best position to provide knowledge of the issues and means to reverse the trend.

Every contractor has or will experience profit fade. Proactively addressing it will not only help mitigate the impact, but also will enhance a contractor's credibility with its surety and banker.

Kevin Doyle
Lanigan, Ryan, Malcolm & Doyle, P.C.
Gaithersburg, MD

Q How will the new revenue recognition and lease accounting standards affect contractors? Are options available to a contractor to avoid the complexities of these new standards?

Answer: For calendar year-end privately held companies, the effective date of the new revenue recognition standard is 2019; and the effective date of the new lease accounting standard is 2020. To comply with the updated revenue recognition standard, contractors will have to evaluate their accounting systems to ensure that idle time/wasted materials and bid costs are not included in the percentage of completion calculation. Additionally, contractors will have to capitalize and amortize mobilization and other early contract costs. Virtually all contractors have leases that will require changes to their lease accounting method under the new lease standard, unless they own their own real estate or have a related real estate holding entity that is included in consolidated statements.

The accounting framework introduced by the American Institute of Certified Public Accountants in 2013 remains a potential option for contractors wishing to avoid the complications involved in adopting the new standards. This alternative to Generally Accepted Accounting Principles (GAAP) is called the Financial Reporting Framework for Small and Medium-Sized Entities (FRF for SMEs). FRF for SMEs retains traditional accounting for revenue and leases, along with several other differences from GAAP, with the goal of simplifying accounting standards.

We have not seen significant use of this alternative in contractors' statements; however, the extensive changes involved with the new revenue recognition and lease accounting standards may stimulate additional interest in the FRF for SMEs.

R. A. Bobbi Hayes
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Albuquerque, NM

Q How can a certified public accountant assist a construction business in minimizing and detecting employee fraud?

Answer: Construction contractors can be particularly vulnerable to asset misappropriation, both in the field and in the office. Smaller contractors typically have fewer resources than their larger competitors, and that situation more often results in fewer anti-fraud controls. Recent studies indicate that fraud schemes that are perpetrated generally have durations of 18 to 36 months before they are discovered, with recovery of losses in only 50% of cases.

The preparation of compilation level financials by a certified public accountant (CPA) requires no discussions concerning fraud, and the preparation of review level financials only requires minimal inquiries to owners about their active knowledge of fraud. Only at the level of audited financials does the CPA actively search for areas in which material misstatements could occur.

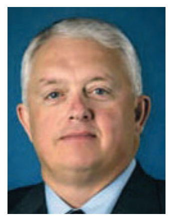
A CPA can be engaged separately to perform a variety of consulting services such as the following: (1) targeted fraud awareness training for employees and managers; (2) assessment of internal controls and segregation of duties and recommendations for improvements; (3) assessment of the specific fraud schemes that pose the greatest threats to the business; and (4) education about which control mechanisms are the most cost effective, such as hotlines and setting a proper ethical tone.

David V. Jean
Albin, Randall & Bennett
Portland, ME

Q How can contractors improve their estimating process to capture overhead?

Answer: One of the most common issues that leads to poor estimating is the lack of an internal standardized estimating process that is clear and consistent. Some construction companies have sales people who also function as estimators. Others have both estimators and sales people. And in many other cases, project managers are also heavily involved in estimating. Improving the accuracy of estimating starts with evaluating and standardizing the process and identifying areas of weakness. Is one project manager bidding on jobs without consulting with the sales person? Is the company president involved, yet not working directly with estimators?

One recommended solution is for contractors to focus on standardization by developing a "master template" or standardized estimating model to promote consistency and capture all possible line items in the estimate. The model or template should include all possible cost line items and serves as a reminder (checklist) to make sure all costs are captured in the estimate. Contractors should clean up any internal communication issues and find an estimating process that everyone uses consistently. Often, using construction industry specific estimating software and approved master templates alleviates these inconsistencies internally. Another simple solution is to conduct a "sanity check" on estimates to ensure that the estimate is reasonable. This also allows time for a second set of eyes to review the numbers, which is extremely important to ensuring the accuracy of the estimating process.



Tim Wilson
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Kansas City, MO

Q What are some of the top risk issues on which a contractor needs to be focused for 2016–17?

Answer: No matter what size a construction company is, the executive leadership team should discuss what business risks they face as a company and develop strategies to mitigate these risks. It's not always a risk that can be insured. Some of the key business risks that construction companies should consider and address in planning a successful business strategy for 2016–17 include the following:

1. Preparing for workforce issues, such as employee retention, training (both safety and professional), recruitment, and compensation, is crucial for the success of the company. A well thought-out strategy to mitigate these risks can help minimize the impact when a key employee decides to leave the company (many times to a competitor).
2. Every contractor in today's environment is dealing with additional investments in technology, both in the home office and the field. Whether it is using mobile devices to record time or replacing entire computer systems, contractors are faced with increasing complexity and costs for technology.
3. Balance sheet management is critical to the success of a construction company. Many construction companies are experiencing an increase in contract activity, which can create stress on the balance sheet of the company. As revenue goes up, often contract accounts receivable and retention go up. The company, however, still has to make payroll, pay material suppliers and subcontractors, and address

other obligations impacting bank credit lines, bonding capacity, and vendor relationships.

Julian Xavier
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Walnut Creek, CA

Q What makes a best-in-class contractor from a financial statement perspective?

Answer: Some key metrics that best-in-class contractors have achieved, which provide comfort not only to their banks and sureties but also to their shareholders, are:

Working capital (current assets less current liabilities) is a key measure of a contractor's liquidity available to perform and complete its contracts. Tangible working capital should be in excess of 7.5% of annual revenues (tangible working capital excludes from current assets items such as prepaid expenses, old receivables, related party receivables, underbillings, and other intangible assets).

Certain items should be excluded from tangible equity, including any goodwill, prepaid expenses, and related party receivables. Additionally, many contractors will deduct items such as the deferred tax liability that will pass through to corporation owners and operating lease commitments that aren't recorded on the balance sheet. Best-in-class contractors should have tangible equity in excess of 10% of revenue.

Overall overbilled position on projects with underbillings on jobs more than 50% complete should be kept to a minimum. Additionally, net overbillings should be "in the bank," indicating that the contractor has done a good job of keeping sufficient funds available to take care of the turn in the overbilled position. Overall overbillings should be at least 2% of annual revenues.

Interest-bearing debt as a percentage of equity should be kept to 50% or less for a labor-intensive contractor and less than 80% for a heavy equipment company. Additionally, total debt (all liabilities) to equity ratio should be less than 3 to 1 for a heavy equipment company and 4 to 1 for a general contractor. ●