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LGT Construction Partners

Lee Ann Collins, Accounting, Assurance & Consulting Partner
lcollins@lgt-cpa.com, 214.461.1466

Bill Walsh, Consulting Partner
bwalsh@lgt-cpa.com, 214.461.1415

Brad Gross, Tax Partner
bgross@lgt-cpa.com, 214.461.1406

Landon McAfee, Assurance Partner
lmcafee@lgt-cpa.com, 214.461.1505

Lance Trammell, Assurance Principal
ltrammell@lgt-cpa.com, 214.461.1470

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The tax implications of the new revenue recognition standard

Last year, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*. The new standard, which takes effect in 2018 for privately held companies (2017 for public companies), creates a single, comprehensive revenue recognition model to replace today's industry-specific — and often inconsistent — rules.

As you prepare to implement the new standard, don't overlook the potential tax implications. In some cases, the new rules may accelerate taxable income or create book-tax differences that you'll need to track and report.

A quick recap

The new standard prescribes a five-step model for recognizing revenue: 1) Identify the contract, 2) identify performance obligations, 3) determine the transaction price, 4) allocate the price among the performance obligations, and 5) recognize revenue when (or as) performance obligations are satisfied.

Today, contractors usually treat a contract as a single performance obligation. Under the new standard, however, certain contracts may be split into two or more distinct performance obligations.

Suppose, for example, that a contract calls for you to construct a building and to supply and install certain equipment. Depending on the facts and circumstances, the contract may be divided into two performance obligations, requiring you to allocate the price between construction and equipment installation and to recognize revenue from each separately.

> *If application of the new standard accelerates revenue recognition for financial reporting purposes, it may also accelerate recognition of taxable income.*

The new standard may also affect accounting for long-term contracts. Typically, contractors use the percentage-of-completion method to recognize revenue over the life of a project. Under the new standard, revenue is recognized when *control* of a good or service is transferred to the customer. Depending on several factors, control may be transferred when the contract is complete or it may be transferred gradually over the life of a contract.

Other areas potentially affected by the new standard include change orders, uninstalled materials, and claims and warranties.

Impact on tax planning

The new revenue recognition standard may affect taxes and tax planning in several ways. Here are a few examples:

Acceleration of taxable income. Under certain circumstances, revenue recognition for tax purposes is required to align with its treatment for financial reporting purposes. So, if application of the new standard accelerates revenue recognition for financial

Measuring progress on a contract

Generally, contractors accustomed to the percentage-of-completion method will continue to use that method under the Financial Accounting Standards Board's new revenue recognition standard, *Revenue from Contracts with Customers* (Accounting Standards Update (ASU) No. 2014-09). In some cases, however, methods of measuring progress toward completion may change. ASU 2014-09 permits several output- and input-based methods, including the traditional cost-to-cost method, but the traditional approach may no longer be appropriate if it's inconsistent with the manner in which control is transferred to the customer.

For example, if a contractor has acquired a significant amount of uninstalled materials, incurred costs may be disproportionate to the contractor's progress in satisfying a performance obligation. Under those circumstances, the new guidance would require the contractor to adjust its measure of progress to exclude those costs, causing revenue recognition for financial reporting purposes to diverge from the traditional tax treatment.

reporting purposes, it may also accelerate recognition of *taxable* income. Suppose, for example, that your contracts call for advance payments. Generally, for tax purposes, advance payments are included in taxable income in the year they're received. But there's a limited exception, which allows you to defer tax on advance payments for goods and services for one year, to the extent they are deferred in your audited financial statements.

In some cases, the new standard's "transfer of control" model may require you to accelerate revenue from advance payments into the year they're received. If this happens, taxable income related to those payments will similarly be accelerated.

Percentage-of-completion method. With certain exceptions, the tax code requires contractors to account for long-term contracts using the percentage-of-completion method. But the new standard may require adjustments to that treatment for financial reporting purposes. (See "Measuring progress on a contract" above.)

If the tax and financial reporting treatments diverge, applying the new standard may create a book vs. tax income difference (or alter an existing book-tax difference) that must be tracked and reported on your tax returns.

Changes in tax accounting methods. If the new standard requires you to change an accounting method for financial reporting purposes, it may be necessary or desirable to make a similar change to the corresponding tax accounting method. Changing a tax accounting method requires you to file Form 3115, "Application for Change in Accounting Method." Depending on the nature of the change, approval may be automatic, or it may require advance consent from the IRS.

System changes. As just described, adoption of the new revenue recognition standard may cause you to change your tax accounting methods, or it may create (or alter) differences between book and tax income. Either way, you must ensure that you have updated systems, policies, processes and controls in place in order to gather the data you need for both financial and tax reporting and to track any book-tax differences.

Start planning now

Even though the new revenue recognition standard won't take effect for two or three years, it's a good idea to begin planning for the change sooner rather than later. As you prepare, be sure to consider the potential impact on your tax returns as well as your financial statements. ■

How to tackle the issue of profit fade

As you know, profit fade can be the downfall of many contractors. But there are several tactics that can help ensure your profits don't fade away in a mist. Here are just a few.

Be aware of any project swings

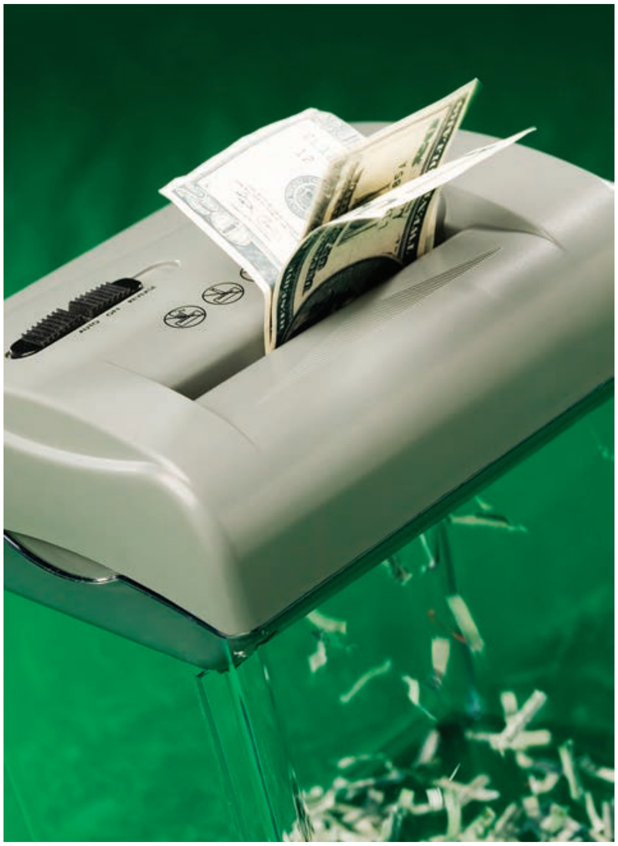
The profit you calculate when bidding a job can fluctuate dramatically as work progresses. For every phase finished under budget, there may be an unexpected problem waiting to wipe out the savings. If you want to end at the top of the arc, stay on top of each project's swings.

Every significant cost increase should be accompanied by a change order that increases the contract's value. If it isn't, determine why. Was your initial estimate off? Or have you done extra work that wasn't covered by a change order? In either case, you're headed for profit fade, and you must find ways to get the job back to "profit friendly" status.

Conducting a careful review of the contract and clarifying any uncertainties at the start of the job can help prevent disruptions and delays going forward.

Dig for clues on why certain projects weren't successful

In addition to monitoring work in progress, study your estimating and profit histories. Review jobs that didn't work out so well to determine where they didn't meet budgets and whether expenses were allocated properly.



Ask your supervisors whether the assumptions you used in estimating the projects were valid. Did you, for example, realistically calculate the number of bricks your crews could lay in a day? Were your average labor costs accurate?

Also consider direct and indirect costs, and compare estimates on jobs that lost money to those on profitable projects. Use those results to improve estimating procedures on future projects. If, for example, projects were delayed because you expected your project manager to obtain final foundation design approvals and shop drawings while also getting the job under way, revisit your staffing estimates.

Look, too, at whether certain owners cost you money. If an owner consistently moved walls or added doors, be sure that any future contracts with the owner include specific language regarding scope and specification changes, change orders and schedule revisions.

Develop lock-tight contract language

Before work begins, understand fully what you're contracted to do. Contract language is often unclear, resulting in differences in interpretations that can disrupt and delay projects. Conducting a careful review of the contract and clarifying any uncertainties at the start of the job can help prevent disruptions and delays going forward.

Also make sure your project managers understand the contract language fully. Meet with them before every project to discuss not only the contractual provisions for scope of work and change orders, but also what you bid and why.

As work progresses, meet with your project managers regularly to make sure they're comparing their actual costs to the bid cost amounts. If a problem arises, they can address it with the owner immediately. They should also note the reason for the issue. For example, if you're typically plagued by weather delays during a certain time of year, you may need to build a little more time into your bids.

If there's a problem, remember that your leverage is strongest *before* the project is finished. Owners need your help to meet their goals, and they may be more amenable to approving change orders while you're still on the job. If you wait until projects are done, owners will have use of the facilities and may not release your retainage. In other words, they're holding all the cards.

It's time to combat profit fade

Profit fade can be perilous to your contracting business and shouldn't be ignored. But there's an upside to proactively combating profit fade: Your surety will be more confident in your ability to make a profit. ■

8 tips for improving productivity

In an industry as labor-intensive as construction, few things can hurt a contractor's profitability more than unproductive workers. Here are eight tips for improving productivity.

1. Don't blame your workers. While it's tempting to blame poor productivity on lazy workers, late starts and excessive breaks, the fact is that most construction workers strive to be productive. More often than not, poor productivity is the result of waste and inefficiencies that are within management's control.

2. Focus on unproductive time. Research by the Construction Industry Institute shows that craft workers typically spend less than half of their time on tasks. The remaining time is spent on unproductive activities, such as waiting for equipment and materials, waiting for instructions or waiting for work areas to be ready. If, for example, workers spend only 30% of their time on direct work, your greatest opportunity for productivity gains is to focus on the 70% of worker time spent *off* task. In other words, reducing the amount of time workers spend *off* task will produce greater benefits than attempting to improve their efficiency during the time they spend *on* task.

3. Conduct an activity analysis. Spend some time monitoring activities on jobsites and analyzing the results. Often, this process will reveal opportunities to improve productivity. For example, better scheduling and logistics can reduce delays that result when workers have to wait for materials or equipment, or for other workers to complete their work. In many cases, solutions are surprisingly simple, such as finding a way to store materials, equipment or tools closer to the areas where they're needed, or storing materials on wheels so they can be moved more easily.

Strategies for reducing personal time — such as locating portable toilets closer to work areas — can also have a significant impact on productivity. On one high-rise project, a structural contractor reduced the amount of time it took for workers to have lunch by arranging for a sandwich shop to operate alongside the structure.

4. Improve communications. Poor communication between supervisors and workers can result in unnecessary mistakes and redo work, causing productivity to suffer. With proper training, supervisors can learn how to communicate assignments to workers and ask the right questions to ensure they get it right the first time.

5. Take advantage of technology. Web-based project management applications, scheduling software, and other technological innovations can boost productivity by speeding up communications, providing workers with the latest project information in real time and making the construction process more efficient.

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6. Set realistic goals. Performance-based incentives can be an effective tool for motivating workers and improving productivity. But it's critical to set realistic goals. If workers feel that performance targets aren't achievable, productivity may actually decline.

7. Pay attention to safety. The most important reason to have a strong safety program is to prevent injuries. But good safety practices also reduce the delays and downtime associated with accidents on the job site.

8. Manage overtime. Excessive overtime can result in fatigue, higher accident rates, absenteeism and worker turnover, all of which can hurt productivity. Proper planning, scheduling and supervision can help keep overtime to a minimum.

Improving productivity is one of the most effective strategies a contractor can employ to boost its bottom line. ■

Working out of state? Don't leave home without a license

In today's competitive environment, an increasing number of contractors are seeking business opportunities across state borders. If you're considering this strategy, start planning as early as possible and give yourself plenty of lead time to comply with out-of-state licensing requirements.

Do your homework

Licensing requirements vary from state to state — and even from city to city — so be sure to research the requirements in the jurisdictions where you seek work. In many (but not all) states, general contractors (GCs) must obtain a license at the state level. In some states, a license is required at the municipal level.

What about subcontractors? Most states require a license for certain specialties, such as electrical, plumbing and HVAC. For other trades, many states waive licensing requirements for subcontractors that work under the supervision of a licensed GC. In some states, subcontractors must be licensed regardless of whether they work under GC supervision. And, for some states, a license is required only if a job's value exceeds a specified threshold ($50,000, for example).

Apply early

Applying for a license can be time consuming, so the earlier you begin the process the sooner you'll be able to take advantage of out-of-state opportunities. Some state licensing boards only consider applications at their quarterly meetings, so be sure to take that into account in determining how much lead time you'll need.

Applications typically request several documents, including:

- CPA-prepared financial statements,
- General liability and workers' compensation insurance certificates (naming the state's licensing board as an additional insured),
- Equipment and asset lists,
- Supplier references,
- Summaries of any litigation or disciplinary proceedings involving your company, and
- Banking information.

Plus, you'll likely need to qualify your company to do business in the state and apply for tax identification numbers. Many states require you or another company representative to participate in training courses and sit for one or more trade or business examinations (although examination requirements may be waived under a reciprocity agreement with your home state). You might find helpful information at contractors-license.org.

Keep in mind that some states require contractors to be licensed *before* submitting a bid, either for all jobs or for jobs above a certain dollar amount. The dollar thresholds may vary depending on whether a project is public or private, so be sure you know a state's requirements before you bid on a job in that state.

A steep price

The penalties for doing business without a license can be severe. In addition to monetary fines, you'll likely lose the job you're currently bidding or working on, as well as the right to work on other jobs in the state, for a specified period of time or even permanently. ■