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CICPAC
CONSTRUCTION INDUSTRY CPAs/CONSULTANTS ASSOCIATION

Looking for a succession strategy? Consider an ESOP

For construction company owners, succession planning can be a challenge. Some owners give the business to their children, but that may not be an option for owners who don't have children working in the company or who need to "cash out" to fund their retirement. Others may sell the business, either to their children or to third parties, but a sale may be difficult if their children lack the necessary resources or they can't find suitable third-party buyers.

Another option is an employee stock ownership plan (ESOP). An ESOP creates an instant market for your stock. And while it involves transferring ownership to employees, it's distinguishable from a management or employee buyout. Unlike a buyout, an ESOP allows owners to transfer control to the next generation gradually. It also provides the business and its owners with significant tax benefits.

What is an ESOP?

An ESOP is a qualified retirement plan, similar to a 401(k). But unlike 401(k) plans — which typically invest participants' funds in a variety of stocks, bonds and mutual funds — an ESOP invests mainly in company stock. Generally, ESOPs are subject to the same rules as other qualified plans, including minimum coverage requirements, nondiscrimination requirements and contribution limits. They also require an annual stock valuation by an independent appraiser.

Distributions to eligible employees are made in stock or cash. For closely held companies (which includes most construction businesses), employees who receive stock have the right to sell it back to the company at fair market value (a "put" option) during certain time windows.

What are the benefits?

An ESOP enables construction company owners to cash out without immediately giving up control over the business. Owners' shares are held in an ESOP trust and voting rights on most issues (other than mergers, dissolutions and other "major" transactions) are exercised by the trustees, who may be officers or other company insiders.

If the business is a C corporation and the ESOP owns at least 30% of its stock, owners who have held their stock for at least three years may defer capital gains on stock sold to the ESOP. To take advantage of this opportunity, an owner must reinvest the proceeds (generally within one year) in "qualified replacement property," which includes most securities issued by U.S. corporations. This allows owners to diversify their holdings without recognizing current gain on the sale of company stock.

ESOPs for S corporations

S corporations that establish ESOPs have several disadvantages — and one major advantage — over C corporations. On the down side, owners aren't permitted to defer gain on the sale of their shares; contributions to cover interest payments *do* count toward the contribution limit; and S corporations can't deduct dividends paid on ESOP shares.

On the up side, however, with proper planning, income passed through to shares held by an ESOP (a tax-exempt entity) escapes federal — and in some cases, state — taxes.

If your construction business is organized as an S corporation and you're considering an ESOP, consult with your tax advisor to carefully weigh the pros and cons.

However, keep in mind that, if selling owners elect to defer capital gains, ESOP rules limit the ability of owners and certain family members to participate in the ESOP or other company retirement plans.

Generally, ESOPs are subject to the same rules as other qualified plans, including minimum coverage requirements, nondiscrimination requirements and contribution limits.

The construction company can also enjoy significant tax benefits, particularly with a "leveraged ESOP." This type of plan borrows the money it needs to purchase the owners' stock and the company makes tax-deductible cash contributions to cover the loan payments. The business essentially deducts its payments for both interest *and principal*. This is a big advantage over ordinary commercial loans, for which only interest is deductible. In addition, contributions to cover interest payments don't count toward the company's contribution limit, and certain dividends paid on ESOP shares are tax-deductible.

What are the disadvantages?

ESOPs offer substantial benefits, but there are some drawbacks. In addition to the usual administrative and compliance costs incurred by qualified retirement plan sponsors, there are costs associated with annual stock valuations and the need to repurchase stock from employees who exercise put options. It's also important to consider the potential negative impact of ESOP debt and other expenses on the company's financial statements and bonding capacity.

Another disadvantage is that ESOPs are available only to corporations. A construction company organized as a limited liability company (LLC), partnership or sole proprietorship would have to convert to the corporate form to take advantage of an ESOP, which raises a variety of financial and tax issues. S corporations are eligible for ESOPs, but they present their own set of pros and cons. (See "ESOPs for S corporations" above.)

Planning your exit

Whichever strategy you choose, start planning several years before your anticipated departure from the business. Exit strategies take time to implement, and the earlier you have your plan in place, the more likely it is to succeed. ■

Public works projects

Here's what you need to know

Public works projects are crucial to the United States economy and to many contractors who are looking for work. But beware: While such projects can bring in much-needed dollars to your construction business's coffer, they can also bring in some unwelcome requirements.

Understanding prevailing wages

Most federal projects are subject to the Davis-Bacon Act, which requires federal contractors to pay what's known as a "prevailing wage." In other words, Davis-Bacon — along with its state counterparts — requires you to pay wages on a public project that are comparable to wages for similar work in the same geographic area.

Earlier this year, President Obama signed an executive order making the minimum wage $10.10 an hour for federal contractors and subcontractors, beginning Jan. 1, 2015. This compares with the hourly federal minimum wage for other workers of $7.25.

What's more, a majority of states impose similar requirements on state-funded projects. And if a project is financed by *both* federal and state funds, the higher wage typically applies.

Determining wage rates

On federal projects, the U.S. Department of Labor (DOL) sets the prevailing wage rates — while, on state projects, the equivalent state agency sets the rates. One of the biggest challenges for contractors who are bidding on public projects is worker classification. Prevailing wages may vary among different classifications, so it's critical that you get them right.

And, complicating matters further, the DOL and state agencies may restrict the types of work that can be performed by workers in certain classifications. As an example, a worker who is classified as a laborer may not be permitted to perform tasks that are traditionally associated with members of a particular trade or craft, such as plumbers or electricians.

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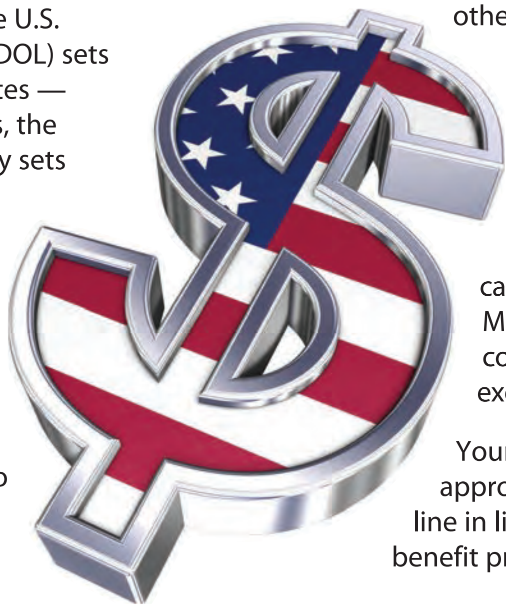

Assessing fringe benefits

Generally, prevailing wage rates consist of a base rate paid in cash and a fringe benefit amount. Contractors have the option of paying fringe benefits in cash or applying fringe benefit credits for contributions to "bona fide" benefit plans, such as health and life insurance, long-term disability plans, retirement plans, and vacation days or other paid time off.

Computing fringe benefit credits is complex, so you might be tempted to simply pay the fringe benefit amount in cash. But satisfying the fringe benefit obligation using bona fide benefit plans can be more cost-effective. Moreover, cash wages are subject to Social Security, Medicare and other payroll taxes, while contributions to benefit plans are generally exempt from these taxes.

Your advisors can help you determine which approach would be better for your bottom line in light of your existing compensation and benefit programs.

Keeping in compliance

Compliance with prevailing wage laws demands timely, accurate record-keeping. You'll need to submit certified payroll reports periodically as well as keep accurate internal payroll records on file. It's particularly important that you document the classification of all your workers and the tasks they perform.

In addition, general contractors and upper-tier subcontractors are responsible for prevailing wage violations by lower-tier subcontractors. So it's extremely important to gather records from these subcontractors to ensure they're in compliance.

Abiding by the law

The penalties for prevailing wage violations can be severe. Under the Davis-Bacon Act, for example, they may include fines, contract termination or even "debarment" from future federal contracts for up to three years. And that's not all — contract payments may be withheld in order to cover the violator's liabilities for unpaid wages and certain other damages.

Moreover, contractors or subcontractors that falsify their payroll records or demand kickbacks of wages are subject to civil and even criminal prosecution.

Next steps

As you can see, prevailing wage laws are quite difficult to maneuver. Because of that, it's critical that you work with your financial advisor before embarking on public projects. A seasoned and knowledgeable advisor could make the difference between a profit or a loss on your next project. ■

Accounting for change orders

Why you need to handle them with care

Change orders are a fact of life in the construction industry. To help ensure a project's success, it's critical that contractors understand the contract's change-order-approval procedures and follow them to the letter.

It's also important to treat change orders properly for accounting purposes, especially for construction businesses that use the percentage-of-completion method. Failure to do so can result in underbillings or profit fade, two major red flags for sureties and lenders.

Avoid these common mistakes

It's not unusual for contractors to begin out-of-scope work before a change order is approved. But failure to properly account for the costs and revenues associated with this work can have a negative impact on a construction business's financial statements. Suppose, for example, that a contractor records costs attributable to a change order in total incurred job costs to date, without making a corresponding adjustment to the total contract price and total estimated contract costs.

If it's probable that the costs will be recovered through a contract price adjustment, the construction business has two choices: 1) Defer the costs until the parties have agreed on the change in contract price, or 2) treat them as costs of contract performance in the period incurred and increase the contract price to the extent of the costs incurred (resulting in no change in estimated gross profit). To determine whether recovery is probable, a contractor should consider its past experience in negotiating change orders and other factors.

To a surety or lender, this may indicate excessive underbillings.

Profit fade can occur if contractors are overly optimistic about their chances of receiving change order revenue. If a contractor increases the total contract price based on out-of-scope work but is unable to secure change order approval, profits may fade as the job progresses, thus shaking the confidence of sureties and lenders.

Know the rules

Generally, change orders fall into one of three categories: 1) approved, 2) unpriced (approved as to scope but not price) and 3) unapproved.

Approved change orders. It's appropriate to adjust incurred costs, total estimated costs and the total contract price. Depending on the contract's change-order provisions, this may increase the construction business's estimated gross profits.

Unpriced change orders. If the parties agree on the scope of work but leave negotiations on price for later, the accounting treatment depends on the probability that the contractor will recover its costs. If it's not probable, change order costs are treated as costs of contract performance in the period during which they're incurred and the contract price is *not* adjusted. As a result, the contractor's estimated gross profit decreases.

If it's probable that the contract price will be increased by an amount that exceeds the costs incurred (increasing estimated gross profit), the contractor may recognize increased revenues, provided realization of those revenues is "assured beyond a reasonable doubt."

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Unapproved change orders. These should be treated as claims. It's appropriate to recognize additional contract revenue only if, under guidance provided in the accounting rules, it's probable that a claim will generate such revenue and the amount can be reliably estimated.

Bottom line

By following these rules, you can improve the accuracy of your financial statements and instill confidence in sureties and lenders.

Taking GPS in new directions

GPS isn't just for navigation anymore. For construction companies, it can be an invaluable tool for monitoring and managing equipment, vehicles and other valuable assets.

Here are several ways contractors are using these systems today:

Protecting against theft. By installing GPS tracking devices in vehicles or equipment, you can track their location and receive alerts if they're taken off site or outside a specified geographic area. And the ability to pinpoint their location enhances the chances of recovery.

Monitoring usage. By wiring a GPS device into an asset's engines and other systems, you can monitor their usage, tracking data such as engine starts and stops, idle time, miles driven, and fuel purchases. Managers can use a computer or mobile device to view all vehicles and pieces of equipment in real time, monitor their activities and review a history of previous activities. This information is invaluable for scheduling and allocating resources among jobs.

It's also possible to integrate a system with your fuel cards, allowing you to track fuel purchases and usage electronically, automate expense and mileage reports, and help prevent fraud. You can even limit purchases to maximum fuel or dollar amounts or prohibit purchases outside working hours.

Tracking employees. By providing employees with GPS-enabled key fobs, you can track individual operators across multiple vehicles and equipment. This helps automate time-keeping and generate more accurate time sheets.

Enforcing safety rules. GPS systems allow you to monitor vehicle and equipment speeds and receive alerts if operators exceed speed limits. They can also warn you if equipment is parked in an unprotected area or if an operator exceeds limits on the number of hours that can be worked in a day.

Complying with local laws. GPS can also help ensure compliance with local city or municipal laws and regulations. For example, suppose a local noise ordinance bans work on a jobsite outside certain hours. The system can alert you if equipment is being operated at a prohibited time.

Assisting in accounting and tax reporting. GPS allows you to track usage, expenses and mileage, making it easier to account for equipment and vehicle costs and to generate supporting documentation for state and federal tax reporting purposes.

Reducing costs. The system can help increase an asset's useful life and avoid costly down time by monitoring usage and engine diagnostics. The system can also alert you when preventive maintenance is required or when a diagnostic system generates a trouble code.

By automating many vehicle- and equipment-related activities, GPS systems can save contractors significant time and money. ■

We've built a solid practice to help you build, well, anything.

GBQ understands that the construction industry requires expertise and knowledge specific to its unique characteristics. Developers, contractors, architects, engineers and builders need a business advisor that understands the daily ins and outs of the industry.

GBQ has a long history of providing outstanding client service to contractors. Our client list includes general contractors, specialty trade contractors, heavy highway contractors, homebuilders and residential contractors. We have a team primarily dedicated to serving the construction industry, and therefore, we understand challenges and issues of all facets of construction.

Think of our certifications as required permits.

GBQ is a member of Construction Industry CPAs/Consultants Association (CICPAC). This national organization, headquartered in Chicago, Illinois, is comprised of CPA firms that have significant practices in the construction industry. Many of the firms who are members of this group also provide valuable input into the various bodies of The American Institute of Certified Public Accountants who set accounting policy for the construction industry. Only one firm may represent CICPAC in each member city and GBQ is the sole representative for CICPAC in Franklin and several surrounding counties.

Our construction services:

- Tax Planning and Compliance
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- Systems and Procedures Analysis
- Bonding and Financing Analysis
- Transaction Advisory Services
- Consulting Services
  - Assistance with quantification of damage and delay claims
  - Construction litigation and support services
  - Calculation of labor burden rates
  - Calculation of overhead recovery
  - Budgeting and cash flow analysis
  - Job costing analysis
  - Succession planning
  - Business valuations
  - Project manager financial training
  - Benchmarking and analytical review

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