Construction
Industry Advisor

Summer 2008

Do you know how to recoup your equipment costs?

Protect your construction company against disbursement fraud

Withholding measure targets government contractors

Mobile faxing: A tool for busy contractors

Contractor's toolbox
5 ways to ensure you hire the best workers

MARTIN HOOD FRIESE & ASSOCIATES, LLC

A CPA FIRM DEDICATED TO EXCELLENCE IN SERVING THE CONSTRUCTION INDUSTRY

Contact our Industry Leaders:

Mark G. Czys, CPA
mark@mhfa.net

Denise V. Martin, CPA
denise@mhfa.net

Mitchell R. Schluter, CPA
mitch@mhfa.net

2507 South Neil Street
Champaign, Illinois 61820
217.351.2000
Fax: 217.351.7726
www.mhfa.net

CICPAC
CONSTRUCTION INDUSTRY CPAs/CONSULTANTS ASSOCIATION

Do you know how to recoup your equipment costs?

Capturing equipment costs can be a challenge, but it's well worth the effort. The secret to success lies in knowing the methods available and how to use them. When the calculations are done, you'll be able to recover your costs by charging them to each contract.

Tracking costs

Tracking equipment costs allows you to evaluate a machine's operating performance more accurately. Costs are usually divided into two categories:

1. Ownership costs. These are incurred regardless of whether the equipment is used in production. The costs include the purchase price (including any applicable interest), taxes, storage and depreciation. A major repair, such as overhauling a blown engine, may fall under ownership costs if you budget in advance for such an emergency.

2. Operating costs. Any expenses you incur when using equipment, such as fuel, labor and minor repairs, are operating costs. They vary according to how much you use the equipment. If you subject your equipment to harder-than-average use or your fleet is aging, you may need to factor in more frequent preventive maintenance.

Understanding depreciation

Depreciation is the decrease in a machine's value over time because of age or technological obsolescence. It's typically calculated using a straight-line method for determining equipment billing rates and financial reporting. The salvage value of a machine — the value you expect it to have at its useful life's end — is subtracted from the purchase price and divided by its total estimated useful life. For example, if you purchase a $50,000 piece of equipment and expect its salvage value to be $2,000 at the end of a seven-year useful

life, the annual straight-line depreciation amount would be $6,857 [($50,000 – $2,000) ÷ 7].

The Modified Accelerated Cost Recovery System (MACRS), used to figure depreciation deductions for tax purposes, allows for a greater amount of depreciation expense (and thus greater tax savings) in the early years of an asset's life. So, if you purchase the same piece of equipment using a seven-year life, depreciation for the first year would be $7,143 ($50,000 ÷ 7); $12,245 for the second year {[($50,000 - $7,143) ÷ 7] x 2}. Note that salvage value isn't considered for tax purposes.

Recouping costs

Equipment costs should be charged to each contract using a method that reflects the extent to which the equipment was used on that job. A common approach is to develop internal billing rates based on the actual cost of owning and operating the equipment. You already know what the equipment will cost, and the dealer can provide other pertinent information that will help when setting your rates, including the estimated repair costs, taxes, insurance and fuel, and the estimated useful life.

Equipment costs should be charged to each contract using a method that reflects the extent to which the equipment was used on that job.

When calculating equipment costs, the purchase price and interest are totaled and then divided by the estimated years in service to get an annual acquisition cost. Next, the costs for repairs, taxes, insurance and fuel and so forth are totaled and added to that annual acquisition cost. The total of those two numbers represents your annual costs. Finally, the annual costs are divided by the number of hours you expect to use the equipment in a typical year. The result is the average rate you'll need to charge per hour to cover your costs. (See the chart for a detailed example.)

Calculating an internal equipment rate

Bob, a commercial contractor, purchased a new excavator in 2008. Here's an example of how the internal hourly billing rate would be calculated for the new equipment.

Purchase price	$30,000
Interest or internal capital cost[1]	+ 5,642
	$ 35,642
Estimated years in service	÷ 8
Annual acquisition and interest cost recovery	$ 4,455
Annual operating costs	+ 10,900
Total annual costs	$ 15,355
Hours in service per year	÷ 1,000
Billing rate per hour	$ 15

[1] *Assumes 7% interest rate over a 60-month financing period.*

Another option is to charge for equipment use based on rates published in industry cost guides, such as the *Rental Rate Blue Book for Construction Equipment* and the U.S. Army Corps of Engineers' *Construction Equipment Ownership and Operating Expense Schedule*. You'll still charge hourly, daily, weekly or monthly amounts for use of specific pieces of equipment, but you charge industry rates rather than your own.

Generally, your internal billing rate is the most accurate approach because it uses your actual equipment costs rather than those general to the industry. No matter which approach you use, however, you need to make sure that, at least once a year, your rates are in check with your actual costs.

Finding the sweet spot

Finally, invest in an accounting system that includes an equipment-costing module. It will simplify the process of analyzing costs incurred and costs charged to individual jobs so that you can determine if you're charging too much or too little. The goal is to achieve the right balance so your rates reflect your actual costs, and you get back all that you put into your equipment.

Protect your construction company against disbursement fraud

You've taken steps to secure your job sites to prevent equipment and materials theft. But are you doing all you can to protect your bank account? Your goal should be to make sure every disbursement — such as for employee and subcontractor wages, construction materials and administrative expenses — is for authorized and received goods or services and is recorded accurately, thus reducing the risk of internal theft and inaccurate financial reporting. Let's look at some common internal controls for disbursements.

Segregate job duties

Smaller contractors may rely on one or two employees to handle several critical duties. In some cases, a single employee may be responsible for opening the mail, signing checks and overseeing accounts payable. That may be practical, but it can leave you susceptible to fraud.

To make it harder for workers to dip into the till, divide accounting and finance-related responsibilities among multiple employees. For example, have someone who's independent of the vendor payment functions review all new supplier entries. Also, require employees who have disbursement duties to take at least one full week off from work each year. Employees who voluntarily decline vacation time may do so because they're afraid their fraudulent activities will be discovered by those who fill in for them while they're absent.

Make fraud difficult

Ask your bank if it offers the check-matching service known as "Positive Pay." Under this service, you send the bank a list of checks that have been written each day. The bank matches the account number, check number and dollar amount of each check presented for payment against the list you sent. All three components of each check must match exactly or the bank won't pay.

Here are some other simple, but effective, steps you can take:

- Store checks in a secure location and limit the number of employees who have access to them.
- Don't use signature stamps for checks.
- Prohibit checks payable to cash.
- Set a dollar limit with your bank on the amount for which checks can clear without the bank contacting you for authorization.

Finally, protect financial transactions, such as wire transfers and authorization for credit lines and loans, by using passwords and telephone verifications, in which you or another authorized employee approve activities by phone.

Keep employees on their toes

An effective internal control program requires regular monitoring. For example, have bank statements and canceled checks sent directly to you and personally review them. Keep your employees on their toes by performing random, unannounced audits on your disbursement process. If they aren't sure what you're monitoring and when, they may be less likely to attempt to defraud you. By taking these steps, you're putting employees on notice that fraud and theft prevention are high priorities for your company.

Work with your CPA to create an effective internal control environment. He or she can train you on how to monitor your bookkeeping records, invoices, bank statements, payments, journal entries, financial reports and other documents.

Managing risk, improving results

Protecting your company's disbursements effectively is a key step to managing risk while improving your firm's bottom-line results. As a construction business owner, you need to be able to recognize when problems arise and how to address them. Strong internal controls will help indicate variances early on, giving you the opportunity to take corrective measures and minimize losses.

Withholding measure targets government contractors

If you're a contractor that performs work for federal, state or local governments, you may want to rethink taking on public projects after Dec. 31, 2010. That's when Uncle Sam will begin withholding 3% from your total payments under a little-known tax code provision.

Ready for the big squeeze?

Internal Revenue Code Section 3402(t), which was enacted as part of Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005, is designed to close the "tax gap" — the difference between what taxpayers *should* pay and what they *actually* pay.

Advocates of Sec. 3402(t) allege that many government contractors don't pay their taxes and believe the withholding requirement will encourage them to meet their obligations. Contractors, meanwhile, are understandably upset about a measure that targets everyone in an attempt to get at those few that may actually underreport their income.

As the cost of doing business with the government becomes pricier, you may have to assume more debt or equity to finance operations.

Unlike other withholdings, which are adjusted to closely reflect tax liability, this one is based on a construction company's revenue stream, regardless of profit. As a result, if you do public projects, you'll have to hand over more money than you owe. That money will then be withheld until you file your tax return and can claim refunds.

What will it mean to you?

Sec. 3402(t) may impede cash flow for necessary operations, because more of your money will be tied up in withheld payments. Having less free cash for operating expenses may hamper your ability to complete projects and pay your subcontractors and suppliers. This, in turn, may lead to higher construction prices for federal, state and local governments, which can ill afford additional increases.

What could be the long-term effects?

As the cost of doing business with the government becomes pricier, you may have to assume more debt or equity to finance operations. Or you may be forced to raise your bids for government contracts, putting you at a significant competitive disadvantage. You may have little choice but to rely less on revenue from government payments or withdraw from public sector work entirely.

Along with having to deal with restricted cash flow, if you continue to vie for government contracts, you'll also face the administrative headache of keeping track of what's withheld from every government payment so you can seek proper reimbursement. For large contractors, this may mean accounting for withholdings made on thousands of payments each year.

Moreover, Sec. 3402(t) may impede your ability to secure bonding. Stripping away 3% of your working capital increases the risk that you won't be able to complete projects, potentially jeopardizing future performance bonding.

Can you fight Sec. 3402(t)?

As bleak as the future sounds, it could be worse. Since Sec. 3402(t) was enacted, some lawmakers have tried to increase the withholding percentage to 6% and speed up implementation. On the other hand, a bill introduced in the Senate in 2007 would, among other things, repeal the law. That bill has yet to be voted on.

A diverse group of contractors, equipment manufacturers, materials suppliers, labor unions and trade associations is fighting efforts to accelerate the 2011 implementation date and is supporting lobbying efforts to repeal Sec. 3402(t) entirely.

Get ready

You may want to talk with your state and federal representatives about how the law could impact your business. Also talk with your CPA to learn how to prepare for the withholding requirement in case lobbying efforts don't succeed.

Mobile faxing: A tool for busy contractors

Sending and receiving faxes in real time via e-mail is a big boost to contractors on the go. There's no need to be tied to the office for fax machine transmissions of proposals, signed contracts and other documents — you can manage them electronically from job sites or anywhere else, 24/7.

Internet fax services (such as Metro Hi Speed, GreenFax and TrustFax) allow you to send and receive faxes using your e-mail, without installing any software on your computer.

Here's how it works: Suppose a subcontractor needs to send you an estimate for materials needed for a job. He or she would dial your personal fax number (assigned by your fax service) and send the information using a traditional fax machine. The fax service would translate the data into an image file, such as a PDF, which you'd receive in your e-mail as an attachment. You could then print the attachment using a standard printer, save the file to your hard drive or do both.

As long as you have access to e-mail, whether it's from your laptop or cell phone, you can send a fax. You simply attach a scanned image of a document or an electronic file to an outgoing e-mail message and address the message to the recipient's fax number, followed by the name of the fax service. For example, if the destination fax number is 1-555-693-4277 and you are using GreenFax as your fax service, you would address the e-mail to 15556934277@greenfax.com. The fax service would then translate the attachment so a traditional fax machine could read it.

Most Internet fax services charge a monthly fee, which typically covers all telephone connection charges. But there are many services and many plans, so it pays to shop around.

Contractor's toolbox

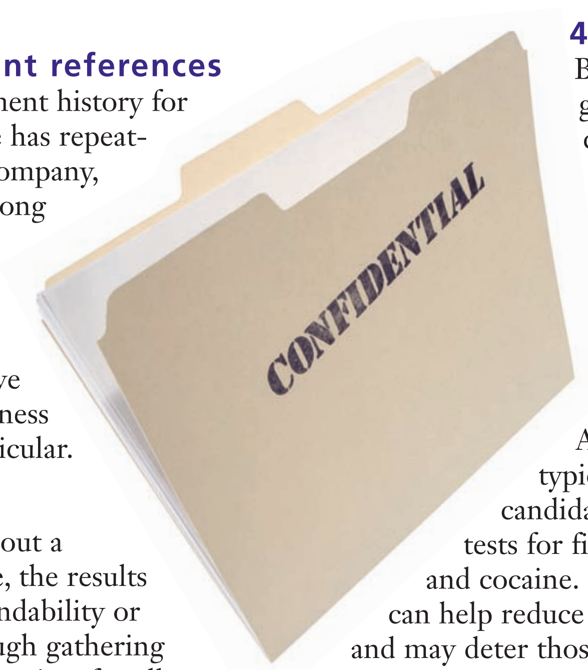
5 ways to ensure you hire the best workers

Your next job candidates should have more than just the right job skills; they also should have a good work ethic, integrity and personalities that will fit into your organization rather than disrupting it.

So how do you find these ideal candidates? Pre-employment screening programs can help you weed out potentially bad apples and upgrade the quality of those you hire. Here's the lowdown on five common screening mechanisms and what they can reveal.

1. Check past employment references

Look at the candidate's employment history for gaps in employment. If someone has repeatedly hopped from company to company, he or she may not stick around long at your organization, either. Be sure to call previous employers to verify employment dates and check out all references. You're likely to obtain the most objective information, however, from business references … supervisors in particular.



2. Look at credit history

Credit checks can reveal a lot about a potential employee. For example, the results may indicate an applicant's dependability or character, or lack thereof. Although gathering credit histories may not be appropriate for all employees, if you're filling a job for a financial or executive position, a credit report is a good idea. If the applicant is in financial trouble, you should think twice before hiring him or her for a financial position.

All three credit bureaus — Equifax, Experian and TransUnion — can provide credit information, though you must have the candidate's written consent to obtain it. If you use a third-party agency to conduct the checks, be aware that you'll be subject to the provisions of the Fair Credit Reporting Act.

3. Uncover criminal histories

Most criminal checks include a scan of national and state sex offender registries and a search of county court records. Many states now have court records online. But, before you launch a criminal background check, federal law requires you to obtain the applicant's consent in writing.

4. Use behavioral tests

Businesses use behavioral tests to get a more complete picture of a candidate's priorities and aptitude for certain types of work. A number of standardized tests are available that measure behavioral traits and compare a candidate's profile with those of people who succeeded in similar jobs.

5. Screen for drug use

A qualified clinic or laboratory typically handles drug testing on job candidates. The most basic drug panel tests for five major drugs, including marijuana and cocaine. Screening employees for drug use can help reduce work-related accidents and deaths, and may deter those with problems from applying for jobs with your construction company.

Dig deep and dig often

Use one or a combination of these screening mechanisms when hiring new employees and randomly thereafter to ensure your workforce is "clean." But be aware that federal, state and local laws regulate what information you can gather and how you can use it. Consult an attorney who specializes in labor law to make sure you don't run afoul of the law.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and, accordingly, assume no liability whatsoever in connection with its use. © 2008 CIAsum08

Helping Contractors Build Success

Succeeding in the construction industry takes smart bidding, quality work, savvy management — and the assistance of advisors who know the business and can help move your company ahead.

Martin Hood Friese & Associates, LLC excels in helping construction businesses build their success. We offer a full range of tax, audit, accounting, business consulting and financial planning services tailored to the unique needs of the construction industry.

Our experienced professionals are dedicated to delivering timely, accurate and personalized service that meets the highest standards of quality and integrity. As a result, we have built a strong reputation for helping construction businesses like yours increase their profitability and success.

We are ready to help you with a broad range of tax, accounting and business management issues, including:

- Accounting systems and controls
- Project bidding and estimating
- Change orders and closeouts
- Cost segregation studies
- Tax planning and filing
- Estate and succession planning
- Bonding and financing
- Job costing and project management

We would welcome any questions you may have on the topics discussed in this newsletter or on other issues affecting your business. Please contact our office at 217.351.2000 and let us know how we can be of assistance.

MARTIN HOOD FRIESE & ASSOCIATES, LLC

2507 South Neil St.
Champaign, Illinois 61820
phone 217.351.2000
fax 217.351.7726