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Construction Industry Accounting & Financial Reporting

2018

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Construction Industry
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Chapter 1 – Construction Industry Accounting Review & GAAP Update

Overview and Trends

1. The construction industry has recovered in most regions and most niches
    a. Some contractors had best years ever in 2015-17
2. Bid prices are still tight and low in certain markets and certain niches
    a. GC fees are too low for certain sectors – 2% to 3% stated fees
    b. Large bid lists in certain areas and niches
    c. Heavy highway, infrastructure, education, healthcare, office, warehouse, manufacturing, etc. are good
    d. Retail, church/religious and home building (in certain areas) are flat
3. Contractor balance sheets were damaged by the recession and the increase in work has strained cash flow – some contractors are still struggling to recover.
4. Construction trends:
    a. More self-performed work
    b. Increase in "strategic" mergers and acquisitions
    c. Technology – jobsite field reporting
    d. More focus on internal controls – cost controls, labor, change orders, etc.
5. Bank credit is too tight; surety credit seems too relaxed – Both ask harder questions
    a. Bank covenants, terms and credit limits are more restrictive
    b. Surety covenants, terms and credit limits are more aggressive
6. What do sureties, bankers and other users want from the CPA (audit firm) and contractor CFO/ controller?
    a. Honesty and integrity
    b. Timeliness (monthly and annual reporting)
    c. More reliable internal monthly/quarterly reporting including job schedules
    d. Knowledge of the industry and best of class accounting practices and financial statement disclosures
        - Contract schedules (WIP / CIP schedules)
        - Allocation of indirect costs; no job cost classified as G&A
        - Tax liabilities (distributions) for pass-through entities
        - Comprehensive disclosures – claims, job fade, receivables
    e. Consideration and understanding of financial statement risks:
        - Under billings (Costs in excess of billings)
        - Contract profit fade and losses
        - Significant bid spread
        - Contract risks: liquidate damages, owner prequalification, non-bonded subcontractors, no cost index, etc.
        - Inadequate overbillings (Billings in excess of costs)
        - Inadequate tangible working capital
        - Related party receivables and transactions
        - Inventories
    f. An understanding that the surety is not the "enemy" and surety benchmarks are "good business" – not punitive

Financial Reporting - Red (or Yellow) Flags

1. Audited or reviewed financial statements not prepared by a CPA firm that specializes in construction contractor accounting.
    a. Income not reported on the mandatory percentage of completion method
    b. No contract schedules included in supplemental information
    c. Losses on uncompleted contracts are not recognized in full
    d. Disclaimer or qualification of opinion (basic financial statement and/or supplemental information) – no “different opinions” allowed
    e. Unique contractor disclosures for backlog, significant profit fade/gain, contract claims, etc. are omitted.
    f. Distributions for tax liabilities (LLC, S-Corp) are not disclosed and/or accrued in the financial statements
    g. Incorrect contractor terminology and classifications
    h. JVs are not consolidated proportionately and disclosed properly
    i. Issuance of statement inappropriately delayed past 90 days
2. <u>Net</u> under billings reported on the balance sheet
    a. Costs in excess of billings exceed billings in excess of costs on balance sheet – “phantom asset” and “non-cash income”
    b. Dumb or dishonest? Poor cash flow (at best); job losses/fades (at worst)
    c. Insufficient over billings on the balance sheet (2% of revenue)
    d. Inadequate reserves for contract completion and punch list costs
    e. No allowance for amortization of front end loading
3. Claims or unapproved change orders are included in revenue
    a. Must be segregated on the balance sheet and recorded to the extent of costs incurred only – no profit allowed to be recognized until collected
    b. CPA must report costs and claim recognition separately on the contract schedule and disclose full explanation in financial statement footnotes
    c. Additional red flag indicator: high legal expense
4. Inventories greater than 20% of annual materials purchases
    a. No need to carry more than 90 day supply
    b. Best of class contractors purchase materials as needed
    c. No such thing as “jobsite” inventories – stored materials are job cost
5. Interest bearing bank debt above 100% of equity
    a. The bank has more invested than the contractor owners
    b. Determine bank collateral does not include “all receivables”
    c. Surety should know loan covenants – What is status?
    d. Consider off balance sheet leases – new GAAP requirements in 2020
6. Working capital is borrowed – without line of credit, working capital would be insufficient
    a. “13-month” bank debt
    b. Collateral for true working capital loan should be long-term assets (equipment, land, personal assets, etc.)
    c. If working capital loan is secured by current assets (cash and receivables), surety should question if it is really working capital

7. Investment in unrelated assets
    a. Stock market investments should be from "excess" working capital only
    b. Coal mines, marinas, farms, aircraft, boats, restaurants – dumb stuff!
8. Accounts receivable issues
    a. Any receivable over 90 days
    b. Significant retainage on contracts completed over 90 days
        - Completed contract retainage – ageing issue
    c. Related parties and owners – If collectible, why wasn't it paid back prior to year-end? Can the related party pay? CFO, CPA, Auditor should use skepticism and value the related party asset at net realizable value.
9. Personnel and related issues
    a. High key employee turnover
    b. Absentee ownership
    c. No continuity or succession plan
    d. ESOPs – too many cooks in the kitchen
    e. Bonus program based on uncompleted job profits
10. Other yellow flags
    a. Non-bonded subcontractors and poor prequalification controls
    b. Significant bid spreads
    c. Fixed asset depreciation – excessive useful lives
    d. Unrealistic equipment repair capitalization
    e. Signing bonds for other contractors (bad idea)
    f. Contract schedules do not reconcile to income statement
    g. Backlog risks – new type of work, new geographic region, etc.

Update on Recent GAAP/GAAS Developments

1. Revenue Recognition – ASC Topic 606
    a. Final standard issued 5/28/14 – effective 2019 for private companies
    b. "*Much ado about nothing*" – William Shakespeare; affect of new revenue recognition has been blown out of proportion by CPAs that know very little about construction contractor GAAP and revenue recognition
    c. Most contracts are a single performance obligation satisfied over time and the reporting method will remain substantially the same as current GAAP
        - The contract is one obligation, not separate "distinct" obligations that are normally delivered separately to an owner – and usable by the owner as a stand-alone completed project
        - The contract does not allow conditional completion of certain phases – the entire contract must be completed for the owner to accept the work
        - The contract requires owner to pay contractor a monthly (or periodic) progress payment for completed pay items or percentage
        - There is passage of legal title to work in progress to the owner as payment is made
    d. Segmentation of a contract is required if <u>separate performance obligations</u> exist:
        - The contract work includes <u>optional</u> or <u>conditional</u> contract phases performed separately from other contract obligations

- There are significant claims, unapproved change orders and/or collection issues with contract owner
- The contract includes extended period warranty obligations to be performed separately over multiple years after the contract completion and acceptance. Warranty must be beyond the normal 1-year period and related manufacturer warranty periods.
- The performance of a certain phase, segment or expansion is conditional on benchmarks such as occupancy, sales goals, financing, etc. The conditional or unfunded phase should be segmented.
- If the contract requires contractor provided financing of all or a significant portion of the contract – full or “gap” financing requirement
- Pre-contract services if collection is uncertain

e. The separate performance obligation must be segmented and reported under the percentage of completion method as though it was a separate contract
   - Cost to cost method of revenue recognition or more conservative method
   - It should be disclosed if optional phase is conditional or unfunded at the reporting date

f. Revenue Recognition Standards (ASC 606) require contractors to apply the following process to contracts that could contain separate performance obligations
   - Step 1 – Identify the contract with the owner including enforceability, owner credit worthiness (proof of financing), contract terms, etc.
   - Step 2 – Identify any separate performance obligations
     - ➢ Don’t be stupid, most contracts have none
   - Step 3 – Determine the contract price (contract amount) –
     - ➢ Not difficult 99% of the time
   - Step 4 – If separate performance obligation, allocate the contract amount to each segment
     - ➢ Usually included in the contract agreement and schedule of values
     - ➢ Best of class contractors negotiate the separate performance obligations when the contract is bid or negotiated
   - Step 5 – Recognize revenue for each segment as performance is satisfied for each separate segment as though it was a separate contract.

g. Enhanced disclosures are required by new standard (best of class contractors have complied with this requirement for decades)
   - Type of contract (fixed price, lump sum, cost plus, unit price)
   - Contract owner, location, type of work
   - Onerous contract provisions (completion dates, conditions, labor restrictions, environmental, safety, etc.)
   - As required under current GAAP, the financial statements must include a reconciliation of the WIP/completed contract schedule to the statement of income; collectability issues (including retainage), backlog, etc.
   - Full absorption job costing; G&A remains period cost
   - Disclosure of significant change in contract estimates (fade/gain – lookback) – SOP 94-6 (ASC 275) cumulative and current year impact of change to contract revenue recognition; no prior period adjustment

h. Other issues emphasized by the new Revenue Recognition Standards:
    - Revenue recognition of early completion bonuses or work quality bonuses
    - Revenue recognition adjustment for liquidated damages or contract penalties
        - Recognition of bonuses or penalties should be based on "most probable outcome test" with bias towards the most conservative income recognition
    - Over billing (Billings in excess of costs and earnings) should not be calculated for front-end loading alone – it should include an allowance for completion (punch list) costs, collectability, warranties, etc.
    - Pre-contract costs may be capitalized as contract costs and deferred as under billings (costs in excess of billings) only if the contract is executed or "more likely than not" to be executed in the near term.
        - Review status after the balance sheet date but prior to issuance of the audit report as part of the subsequent event testing

2. Lease Accounting – ASC Topic 842
    a. Final standard issued 2/25/16 – effective 2020 for private companies
    b. No more "off balance sheet" non-cancelable leases
    c. If lease is over 12-month term, record a "right of use asset" equal to the minimum non-cancelable future lease payments
        - Capitalize asset equal to minimum lease payments
        - Record liability for lease payments – current and non-current
        - Equity neutral
        - Impact to working capital for current lease payments
    d. Applies to real property and personal property assets
    e. Related party leases must be capitalized if over 12-month term. The capitalized asset and the related minimum lease payments will be eliminated if consolidation is required.
    f. Us "most probable" test to determine if lease extension options and rent escalation clauses are included in the lease.

3. Subsequent event disclosures – Topic 855
    a. Timeliness issue – delays increase subsequent event period
    b. Coordination of dates for representation letter and opinion letter
        - Available for issuance definition and issue
4. Going concern disclosures – Topic 205
    a. Management must consider going concern issue – no longer just an auditor responsibility
    b. Disclosure for consideration of going concern and related information affecting the decision
        - Disclosure may be required even if going concern opinion not issued
5. Other contractor GAAP and GAAS issues
    a. Joint venture – proportionate consolidation
        - Risk of loss
        - Thinly capitalized
        - Cost or equity method generally not allowed
    b. Claims and unapproved change order recognition

- Limited to cost incurred
- Separate account on balance sheet
- Comprehensive disclosure – status of litigation, arbitration; costs incurred less allowance for legal costs, collectability, etc.; contract issues; owner financial issues

Healthy Contractor Benchmarks

1. Tangible working capital of 10% of self-performed annual revenue
   a. At least 5% to 7.5% of total annual revenue
   b. No 13-month line of credit window dressing
2. Tangible equity of 15% of total annual revenue
   a. At least 10% of self-performed annual revenue
3. Cash balance greater than 5% of annual revenue
   a. Non-borrowed cash
   b. Line of credit of at least 5% of annual revenue
   c. Conservative investment of idle cash – stock market investments of cash in excess of 5% of revenue – and only if working capital exceeds 10% benchmark
4. Debt ratios
   a. Less than 300% total liability to equity ratio
   b. Less than 50% interest debt to equity ratio (80% maximum)
   c. At least 1.50 cash flow coverage ratio on annual debt service
   d. Including operating leases
   e. Long-term debt or LOC must be secured by noncurrent assets
5. No under-billings on contracts in progress
6. Net overbillings greater than 2% of lower of backlog revenue or annual revenue
   a. 5% is best of class
   b. Amortization of front-end load schedule of values over the job period
   c. Allowance for punch list, finishing costs, back charges, liquidated damages, warranty costs, collectability allowance, etc.
   d. Analyze contract gross profit fade/gain to determine benchmark amount
7. Profit fade less than 10% of original estimated gross profit percentage
   a. 5-year trend analysis – sorted by work type, customer, location, etc.
8. Utilize zero gross profit estimate until 10% complete
   a. Until job buy-out, conservative revenue recognition
   b. Matches IRS 10% election
   c. Hold estimated profit at historical percentage until 50% complete
9. Manage accounts receivable
   a. 30-day average collection period
   b. Retainage collection within 90 days of final completion
   c. No significant related party receivables
10. Low fixed general and administrative expenses
    a. No non-allocated indirect costs misclassified as G&A
    b. 2%-4% of revenue
    c. Idle equipment costs should be documented

	Construction Company Inc.				
	Benchmarking Analysis				
1.	**Discretionary Pre-Tax Income and EBITDA**		12/31/2017	12/31/2016	12/31/2015
	Net income (pre-tax)		$ 13,200,000	$ 9,900,000	$ 9,600,000
	Adjustments:				
	Management fees		4,000,000	6,000,000	3,000,000
	Owner bonus - profit distributions		2,200,000	1,700,000	1,200,000
	Gain on sale of equipment		(650,000)	(200,000)	(320,000)
	Adjustments to revenue for:				
	POC increase (decrease) - deferred revenue		1,900,000	(200,000)	3,100,000
	Insurance reserve (decrease)		(25,000)	50,000	100,000
	Discretionary pre-tax income		***20,625,000***	***17,250,000***	***16,680,000***
	EBITDA adjustments:				
	Depreciation		7,700,000	7,400,000	6,700,000
	Interest expense		500,000	450,000	400,000
	Discretionary EBITDA		***$ 28,825,000***	***$ 25,100,000***	***$ 23,780,000***
	Equipment purchases - Cap-Ex		(5,800,000)	(12,000,000)	(6,000,000)
	Net cash provided - net of Cap-Ex		**23,025,000**	**13,100,000**	**17,780,000**
	Valuation at 7x EBITDA		$ 201,775,000	$ 175,700,000	$ 166,460,000
	Valuation at 7x Average EBITDA (4-year)		$ 155,627,500		
	Total equipment purchased since 2014 - Cap-Ex		$ 25,300,000		
	Total discretionary EBITDA since 2014		$ 88,930,000		
2.	**Key ratios and benchmarks**	Goal	12/31/2017	12/31/2016	12/31/2015
	Balance Sheet				
	Cash and equivalents		$ 26,000,000	$ 18,000,000	$ 22,000,000
	Cash to revenue percentage	*>5%*	*13.5%*	*11.0%*	*12.8%*
	Working capital		25,000,000	18,000,000	17,700,000
	Working capital to revenue	*>10.0%*	*13.0%*	*11.0%*	*10.3%*
	Tangible working capital		21,500,000	14,500,000	14,200,000
	Tangible working capital to revenue	*>7.5%*	*11.2%*	*8.9%*	*8.3%*
	Tangible WC to self performed revenue	*>10%*	*13.0%*	*11.5%*	*10.7%*
	Stockholders equity		44,000,000	38,000,000	36,000,000
	Stockholders equity to revenue	*>10%*	*22.9%*	*23.3%*	*20.9%*
	Tangible Stockholders equity		40,000,000	34,000,000	32,000,000
	Tangible equity to revenue	*>15%*	*20.8%*	*20.9%*	*18.6%*
	Tangible equity to self-performed revenue	*>15%*	*0.0%*	*0.0%*	*0.0%*
	Total related party receivables		2,000,000	2,500,000	1,800,000
	Underbillings		1,300,000	1,100,000	500,000
	Overbillings (job borrow)		9,300,000	7,200,000	6,800,000
	Net overbilling		**8,000,000**	**6,100,000**	**6,300,000**
	Net overbilling to revenue	*> 2.0%*	***4.17%***	***3.74%***	***3.66%***
	Cash to net overbilling ratio	*>150%*	*325.00%*	*295.08%*	*349.21%*
	Total interest bearing debt		16,500,000	13,000,000	14,500,000
	Interest debt to equity ratio	*< 60%*	*37.5%*	*34.2%*	*40.3%*
	Interest debt to tangible equity ratio	*< 80%*	*41.3%*	*38.2%*	*45.3%*

Operations	Goal	12/31/2017	12/31/2016	12/31/2015
Revenues		$ 192,000,000	$ 163,000,000	$ 172,000,000
Subcontract expense		(27,000,000)	(37,000,000)	(39,000,000)
Revenues - self performed - net of subs		165,000,000	126,000,000	133,000,000
Gross profit		17,600,000	16,500,000	15,400,000
Gross profit percentage	*> 8%*	9.2%	10.1%	9.0%
GP % - net of subs	*>10%*	10.7%	13.1%	11.6%
General and administrative		10,600,000	14,300,000	10,000,000
G & A to revenue	<7%	5.5%	8.8%	5.8%
G & A before mgmt fees & profit bonus		4,400,000	6,600,000	5,800,000
G & A to rev. before mgmt fees	*<3%*	*2.3%*	*4.0%*	*3.4%*
Net income		7,000,000	2,200,000	5,400,000
Net income before mgmt & profit bonus		13,200,000	9,900,000	9,600,000
Net income % before fees & bonus	*> 2%*	*6.9%*	*6.1%*	*5.6%*
Net income before mgmt & profit bonus & deprec		20,900,000	17,300,000	16,300,000
Cash flow coverage - over 40% of debt	*> 200%*	*316.7%*	*332.7%*	*281.0%*
Contract backlog revenue		90,000,000	86,000,000	64,000,000
Contract backlog - estimated gross profit		8,100,000	7,600,000	6,900,000
Contract backlog - estimated gross profit %	*>10%*	*9.0%*	*8.8%*	*10.8%*
Contract backlog - gross profit to G&A	*> 50%*	*76.4%*	*53.1%*	*69.0%*
Equipment and Shop	Goal	12/31/2017	12/31/2016	12/31/2015
Original cost of equipment and plants		$ 53,000,000	$ 51,000,000	$ 41,000,000
Book value of equipment and plants, net		27,000,000	29,000,000	18,000,000
Newness ratio (BV / cost)	*> 40%*	51%	57%	44%
Number of equipment pieces (rolling stock only)		248	231	226
Mechanics - average number employed		11	10	12
Equipment pieces per mechanic	*< 24>*	22.5	23.1	18.8
Total budgeted hours per piece @1200		297,600	277,200	271,200
Hours charged to plants and job cost		244,000	211,000	185,000
Utilization rate - company average	*> 80%*	82%	76%	68%
Employment benchmarks		12/31/2017	12/31/2016	12/31/2015
Total persons employed - total for the year		399	422	421
Average full time employees - weekly		343	341	312
Turnover amount		56	81	109
Turnover rate	< 25%	16.33%	23.75%	34.94%
1st year (rookie) employees on year-end payroll		28	35	41
Percentage 1st year employees	< 10%	8.16%	10.26%	13.14%
Self performed Revenue per employee (average full time)		$ 481,050	$ 369,501	$ 426,282
Pieces of equipment per employee	< .80	0.72	0.68	0.72

Chapter 2 – Financial Reporting & Disclosure Requirements for Construction Contractors

1. **Financial statement format and supplementary information**
   a. Classified balance sheet is required
      - Working capital is a significant assertion
      - "Tangible" working capital is the construction industry term
      - *Will the asset be available to "make payroll" during the 12-month cycle*?
   b. Professional skepticism required for inclusion as current asset or current liability:
      - Under-billings on CIP
      - Retainages with collection period beyond normal contract term
      - Retainages on completed contracts – over 90 days
      - Receivables from claims and unapproved change orders
      - Related party receivables
      - Prepaid expenses
      - Inventories (2nd most over-reported current asset)
      - Current income tax liabilities for pass-through entities – "*accrued distributions for owner tax liabilities*"
      - Restricted cash pledged for high-deductible insurance liabilities
   c. If material, segregate and disclose certain accounts in the financial statements:
      - Retainage receivable on contracts (segregate amounts due from completed and uncompleted contracts in footnotes)
      - Subcontractor retainage payable
      - Receivables from claims and unapproved change orders recognized as contract revenue
      - Accrued losses on contracts in progress
      - Reserves for high deductible self-insurance
      - Direct costs incurred for labor & burden, materials, subcontracts, equipment, indirect cost allocation and other direct costs
   d. Supplementary information should include:
      - Detailed schedule of general & administrative costs (should not include unallocated indirect costs)
      - Detailed schedule of unallocated indirect costs – reported as reduction to gross profit even if not allocable to individual contracts
      - Schedule of retainage segregated by completed and uncompleted contracts
      - Completed contract schedule – job-to-date and year-to-date contract revenue, costs, gross profit, gross profit percentage; sort contracts by type of work or operating division
      - Contracts in Progress (CIP or WIP schedule) – job-to-date and year-to-date revenue, costs and gross profit; estimated contract revenue, estimated costs and estimated gross profit; percentage of completion calculations

2. **Contractor's footnote disclosure for <u>Summary of Significant Accounting Policies</u> should include the following:**
   a. Operations – consider inclusion:
      - Type of work – retail, commercial, healthcare, multi-family, infrastructure, residential
      - Hard bid or negotiated
      - Contract terms: Lump sum / fixed price, unit price, cost plus, cost plus with guaranteed maximum price (GMP), cost plus with shared savings, time and material, force account, etc.
      - Surety bonding requirements – percentage of bonded work with collateral and other requirements (owner personal guarantee)
      - Subcontracted vs. self-performed
      - Geographic location of work
      - Major customers
      - Contractor licensing and prequalification
      - Materials manufacturing and mining (asphalt, concrete, aggregates, steel fabrication, etc.)
   b. Consolidation / Combining information
      - Subsidiaries and affiliates
      - Variable interest entities (VIEs) – Litmus test: Consolidate if VIE will "materially affect the conclusion of the user"
   c. Joint Venture consolidation
      - Usually required as a VIE
      - Proportionate consolidation recommended – no equity or cost basis; Combine proportionate share of assets, liabilities, revenue and costs; report full contract on WIP schedule with reduction for JV Partner share
      - Full consolidation with non-controlling interest reduction can be materially misleading (unless 80%+ JV ownership)
   d. Revenue Recognition - Percentage of Completion method and calculation
      - Separate performance obligation and segmented contracts, if any
      - Cost to cost calculation
      - Exceptions to cost to cost with managements' reasoning
      - Claims and change order recognition policy
      - Loss contract accruals
      - Zero profit estimate policy, if applicable
   e. Use of Estimates
      - Subsequent transactions and event consideration
      - Adjust total costs on completed contracts for amounts incurred through end of field work

  - Revise estimated costs to complete on CIP if subsequent costs indicate costs have exceeded projections

f. Subsequent events – date
  - Include information on significant events or transactions

g. Equipment information
  - Depreciable lives used for major categories – it matters
  - Capitalization policies
  - Impairment of long-lived assets

h. Tax methods and calculation of liabilities
  - Current and deferred tax for C-Corporations, S-Corporations & LLCs
  - Deposits and credits paid prior to year-end
  - Remaining distributions accrued or anticipated before 1/15 or 4/15
  - Material impact to working capital and available cash?

i. Concentration of risk
  - Cash and investments- Revenue and receivables

3. Required Footnote Disclosures – Unique to Construction Industry Reporting

a. Contract Backlog
  - Reconcile to CIP (WIP) schedule
  - Add subsequent contracts signed from year-end to opinion date - conclusion of field work
  - Subcontracted amounts and net self-performed work
  - Surety information – total outstanding surety bond exposure
  - Subcontractor surety information – self-insured risk

b. Significant Changes in Contract Estimates – SOP 94-6 / ASC 275
  - Reporting significant “fade/gain” or “lookback” impact
  - Current and job-to-date adjustment related to the change in estimate
  - Loss contracts and accrued amount
  - Explanation for estimate change or loss accrual “egg on your face”
  - Anticipated completion dates for problem jobs

c. Pending claims or change order litigation
  - Plaintiff and defendant (owner / subcontractor)
  - Brief explanation of issue, legal basis for claim, management opinion and accounting recognition
  - Satisfaction of auditor skepticism
  - Recognized to the extent of costs incurred only – no profit
  - Allowance for collectability, legal costs, hazards of litigation
  - Consideration of prior experience / historical claims collection
  - Total amount of claim and reported amounts, if any
  - Mediation, arbitration, court process – with timetable for conclusion
  - Collateral issue – restricted cash, receivables, bond, etc.

d. Income taxes for pass-through entities
   - Current and deferred tax liabilities – methods and calculations
   - Deposits and credits
   - Accrued distributions – managements' intent

e. Other footnotes unique to contractors
   - Joint Ventures – summary of operations and JV financial statement
   - Equipment footnote – leases, methods, useful lives, financing, etc.
   - Revolving long-term line of credit – secured by non-current assets
   - Surety or banking covenants
   - Contractor provided "Gap" financing
   - Subcontractor default insurance – SDI or "Sub-guard"
   - Retirement and pension plan issues – Multi-employer liabilities

Sample Footnote – Contract Backlog and Related Commitments

Note 10 – Contract Backlog and Related Disclosures

The following schedule is a reconciliation of backlog representing the amount of revenue the Company expects to be realized in future periods from signed contracts at December 31, 2017:

Backlog at December 31, 2016	$30,000,000
Change orders and adjustments to contracts	6,000,000
New contracts signed in 2017	49,000,000
	$85,000,000
Less: Contract Revenues Earned for the Year Ended December 31, 2017	(54,000,000)
Backlog at December 31, 2017	$31,000,000

Subsequent to year-end through February 12, 2018, the Company signed additional construction contracts with total revenues of $19,000,000.

The Company is generally required to furnish performance and payment surety bonds to contract owners. During the year ended, Zurich Surety Company issued $38,000,000 of new surety bonds to contract owners. The bonds are secured by receivables from bonded contracts and a general guarantee from the Company. Also, Zurich required a personal guarantee from the Company's stockholders. At December 31, 2017, surety bonds for contracts totaling $68,000,000 remained outstanding on uncompleted contracts with a current backlog amount of $27,000,000.

Of the $31,000,000 backlog amount, $18,000,000 has been subcontracted to various specialty subcontractors. The Company's policy requires a surety bond from all subcontractors for subcontracts in excess of $500,000, with few exceptions. At December 31, 2017, surety bonds from the subcontractors support approximately $14,000,000 of the subcontracted backlog. Due to the Company's internal controls over subcontractor prequalification, no accrued liability was considered necessary by management for financial guarantees related to the $2,000,000 of non-bonded subcontractors.

Sample Footnotes – Significant Changes in Contract Estimates and Loss Contracts

Note 11 – Significant Changes in Contract Estimates

During the year ended December 31, 2017, certain contracts required significant changes in estimated contract costs, costs to complete and gross profit amounts.

Contract Number	Description		Est/Actual Contract GP (loss) 12/31/17	Estimated Original Gross profit 12/31/16	Change in Contract to date GP (loss)	Current Year to date GP (loss)
2014-14	Nashville 1-40 bridge*	(1)	$100,000	$250,000	($150,000)	($ 25,000)
2014-45	Atlanta 1-75 bridge*	(2)	400,000	200,000	200,000	300,000
2015-46	Knoxville Hwy 11 bridge	(3)	(300,000)	400,000	(700,000)	(500,000)
2015-82	Memphis EP Parkway	(4)	(20,000)	120,000	(140,000)	(80,000)
			$180,000	$970,000	($790,000)	($305,000)

*Indicates that contract was 100% completed and accepted at 12/31/17
(1) Contract profit fade due to failure by non-bonded guardrail subcontractor
(2) Contract profit gain due to quantity overrun of high-profit excavation pay item
(3) Contract profit fade and loss due to bid error in cost of production and erection of concrete bridge beams. Error due to design mistakes and unanticipated steel price increase. Contract is 95% complete at 12/31/17
(4) Contract profit fade and loss due to delays caused by excessive rain and flood damage on jobsite. Contract is 62% complete at 12/31/17

Note: *For illustration purposes, all contracts were 50% complete at 12/31/16*

NOTE 12 - Accrued Loss on Uncompleted Contract

The Company anticipates a loss on contract #1216-10, Tennessee DOT I-75 Asphalt Paving. The total estimated loss was caused by the failure of a guardrail subcontractor to honor their pre-bid quotation. The guardrail subcontractor submitted a quote that failed to meet the contract specifications. The replacement of the subcontractor resulted in an increase to guardrail budgeted costs of $450,000 over the original bid amount resulting in an estimated total contract gross loss of $150,000. As explained in Note 1, it is the Company's policy to recognize the entire anticipated loss on a contract during the period when such a loss becomes apparent, as required by GAAP. At December 31, 2017, the contract was 20% complete and is scheduled to be completed prior to the contract completion date of June 1, 2018.

The contract revenue has been adjusted to recognize the entire $150,000 estimated loss at December 31, 2017 and is reflected as an accrued loss on the balance sheet.

Sample Footnote – Income Taxes for Pass-Through Entities

Note 13 – Income Taxes

The Company uses the percentage of completion method of reporting revenue from long-term construction contracts for financial reporting purposes and uses the Code Section 460 tax percentage of completion method for tax purposes. Non-long-term contracts are reported for tax purposes on the cash basis method.

The Company has elected to be treated as a Partnership Limited Liability Company (LLC) under the Internal Revenue Code. As required, the LLC Company passes through items of income and expense to the Members (owners) each year and thus pays no federal or state income taxes itself. However, the operating agreement and prior year practices require the LLC Company to distributed cash to the Members as capital distributions or bonuses to pay income taxes attributable to LLC Company earnings.

At December 31, 2017, current federal and state income tax liabilities passed through to the Members using an estimated effective tax rate of 30% are summarized as follows:

Estimated taxable income	$3,200,000
Estimated blended effective tax rate	x 30%
Income tax liability related to 2017 pass-through income	960,000
Less: Withholdings and estimated tax payments	(200,000)
Estimated stockholders' current income tax liability	$ 760,000

The LLC Company will distribute $760,000 to the Members in 2018 for the payment of their 2017 income tax liabilities on January 15, 2018. ***These distributions have been accrued in the accompanying balance sheet at December 31, 2017.***

Although not accrued in the accompanying financial statements, cumulative non-current deferred federal and state income taxes passed through to the Members at December 31, 2017, are summarized as follows:

	Current	Long-Term	Total
Fixed assets	$ -	$750,000	$750,000
Prepaid expenses	97,500	-	97,500
Insurance reserve	(113,750)	-	(113,750)
Contract accounting deferrals	135,000	-	135,000
Deferred compensation	-	(19,250)	(19,250)
Net deferred tax liability pass-through	$118,750	$730,750	$849,500

Sample Footnote – Contract Claim / Unapproved Change Order Receivable

NOTE 14 - Contract Claims Receivable

The Company has filed two contract claims with the Tennessee Department of Transportation (TDOT) totaling approximately $920,000. The contract requires mandatory arbitration to settle the claims and related disputes. The arbitration is schedule for July 12-15, 2018. A mediation is scheduled for April 2018. Management and company legal counsel anticipate the settlement of both claims at mediation but are prepared for arbitration if necessary. If the litigation is settled or arbitrated in favor of the Company, payment is required within 60 days.

Both claims are related to a delay by TDOT in obtaining the right-of-way prior to awarding the contract. TDOT failed to complete negotiations with utilities and land owners as required by the contract resulting in approximately 130 days of delay in starting the contracts. TDOT has offered approximately $400,000 to settle the claims prior to arbitration.

At December 31, 2017 management has recorded revenue related to the claims equal to the current offer from TDOT, which is less than the net costs incurred.

	Contract 1216-3	Contract 1216-4	Total
Total claim including profit	$ 720,000	$ 200,000	$ 920,000
Costs incurred	$ 645,000	$ 175,000	$ 820,000
Estimated litigation cost	(45,000)	(25,000)	(70,000)
Subtotal – net costs	600,000	150,000	750,000
Discount*	(300,000)	(50,000)	(350,000)
Contract claim recognized	$ 300,000	$ 100,000	$ 400,000

* Although management anticipates recovery of the full claim amount, a discount was taken for conservative accounting recognition to match the amount offered by TDOT.

Sample Footnote – Stock Redemption / Continuity Plan Liability Disclosure

NOTE 15 - Continuity Plan Contingent Liability

The Company stockholders have entered into a stock redemption agreement. The redemption of stock is not mandatory, except in the event of death.

In the event of a stockholder's death, the Company must repurchase all shares from the stockholder's estate. The purchase price of the stock will be based on the stated redemption price updated annually by the stockholders. At December 31, 2017, the stated purchase price was set at $4,500 per share. The agreement requires the Company to maintain life insurance policies on the stockholders. If the life insurance proceeds are not sufficient, the remaining balance, plus interest, will be paid to the deceased stockholder's estate in one hundred-twenty equal monthly installments.

At December 31, 2017, the 1,500 shares of outstanding stock are owned equally by the two stockholders (750 shares each). The contingent liability related to the redemption of each stockholder is summarized below:

Purchase price at death ($4,500 x 750 shares outstanding)	$3,375,000
Life insurance in force for buy/sell purposes	(2,000,000)
Unfunded purchase price at death	$1,375,000
Annual contingent liability, excluding interest ($1,375,000 ÷ 10 years per agreement)	$ 137,500

Chapter 3 - Contract Schedules & Percentage of Completion Method

1. Next to the balance sheet and statement of income, the contracts in progress schedule is the most important financial report in construction accounting. The CIP schedule has multiple names:
    a. CIP schedule (contracts in progress)
    b. WIP schedule (work in process or progress)
    c. POC schedule (percentage of completion schedule)
    d. Uncompleted contract schedule
2. Surety association survey ranked the contract schedules as #1 disclosure
    a. CIP schedule, completed contract schedule and reconciliation
    b. <u>See Exhibit A</u> – Contract Schedules
3. Inclusion in audit report is required as supplemental information
    a. Short-form version is still permitted
    b. Access to long-form report should be limited
4. Key components of a contractor's balance sheet and statement of income are a product of the contract schedules:
    a. Revenue, cost and gross profit recognition
    b. Costs and estimated earnings in excess of billings on CIP(under-billings)
    c. Billings in excess of costs and estimated earnings on CIP(over-billings)
    d. It is mathematical malpractice for a CPA to issue an unqualified opinion on the basic financial statement (balance sheet and income statement) and qualify or disclaim an opinion on the CIP schedule.
5. Analytical procedures to consider in reviewing the CIP schedule:
    a. CIP schedule should be informative and reflect important information about contracts:
        - Type of work
        - Geographic location (county, state, country)
        - Contract owner
        - Type of contract (lump sum, cost plus, unit price)
        - Completion date issues and related liquidated damages
        - Early completion bonuses – recognized and unrecognized
        - Segmentation for separate performance obligations
    b. Historical completed contract gross profit percentage
        - **<u>5-year historical profit "fade/gain" analysis</u>** sorted by type of work, division, customer, project manager, etc. (lookback schedules)
        - Compare to CIP gross profit estimates
    c. Contract risk analysis – <u>Exhibits B & Exhibit C</u>
        - Convert contract gross profit estimates to historical percentages and compare to current estimates
        - Calculate materiality of gross profit recognized in excess of historical results
    d. Under billed contracts
        - Historical analysis of prior year under billing realization

- Substantiate under billed amounts to schedule of values to identify specific labor, materials or subcontract costs paid, but not billed
- Consider write down of under billings without tangible support
- Be skeptical of old excuses: "*cut-off billing date", "most profitable work is last", etc.*

e. Overbilled contracts
    - Front end loading analysis to assess adequacy of the overbilling amount – See Exhibit D
    - Indicates conservative gross profit reporting
    - "*Overbilling should be in the bank"*
    - Permanent job borrow is amount of gross profit included in front-end loading. Technically, an increase to working capital.

f. Overbilling is a "reserve" or "allowance" for several considerations other than front-end loading:
    - Reserve for uncollectible amounts (bad debt, liquidated damages, back charges, quality deductions, retainage offsets, etc.)
    - Punch lists and other non-billable finishing/completion costs
    - Risk associated with subcontractor failure or performance issues
    - Risk associated with price escalation issues
    - Warranties and other call-back costs

g. Full absorption job costing to verify that cost to date amounts are consistent with total estimated cost components and allocation methods
    - Direct costs
    - Indirect costs (systematic and rational allocation)
    - Unallocated indirect costs (idle equipment and labor)
    - General and administrative costs – remain period costs

h. Amount of contract backlog subcontracted
    - Risk associated with non-bonded subcontractors

i. Use of cost to cost percentage of completion method unless another method is more conservative (i.e. labor hours, units, etc.)
    - Significant risk to deviate from cost to cost method which results in the recognition of additional contract revenue

j. Loss contract accrual (GAAP only)

k. Revenue from claims and unapproved change orders should never be recognized as under billings (or overbilling reductions)
    - Revenue recognized from claims or unapproved change orders should be recorded separately on balance sheet
    - Costs associated with claim or unapproved change order should be segregated on CIP schedule to prevent revenue recognition

l. Backlog gross profit
    - Compare CIP gross profit percentage to 5-year completed contract percentages – sorted by major types of work

m. Reconciliation to statement of income (job to date reconciled to year to date or other reporting period)

6. CIP and Completed Contract Schedule – Disclosure and Presentation
    a. Contract description should include:
        - Type of work
        - Contract owner
        - Type of contract (lump sum, cost plus), if different
        - Location (county, state, country)
        - Consider sorting contracts by these parameters if significant
    b. Significant change orders
    c. Separate line for claims or unapproved change orders
    d. Loss accrual column or notation
    e. Footnote explaining any method used other than cost-to-cost
    f. Significant issues
        - Late receivables or retainages
        - Delays and liquidated damage issues
        - Other legal issues
    g. Idle equipment (unallocated) costs – reporting and disclosure – Exhibit A
    h. Homebuilder CIP schedule should include spec home information – Exhibit E
7. Other issues:
    a. Old sayings are true:
        - *"Net under billing is dumb or dishonest"*
        - *"Under billing is not normal; overbilling should be in the bank"*
    b. Disclosure requirement for significant change in contract estimates
        - Significant gross profit fade
        - Loss contracts
        - Gain contracts can indicate "income parking" in prior year
        - See Chapter 2 page 2-5 for sample footnote – SOP 94-6 (ASC 275)
    c. Best practice trend:
        - Use of zero profit estimate until 10% complete – conservative revenue recognition until job is "bought out" and bid is converted to budget
        - Use lower estimated gross profit or historical gross profit estimate until at least 50% complete
    d. Internal control procedures
        - Lock out project managers from ability to post journal entries and adjustments to job cost – to prevent cost shifting – Exhibit F
        - Bid costs should be converted to reasonable job cost pay items "phase coding" or "cost coding"
        - Project managers must have ability to compare actual cost by budget item to bid costs daily
        - Daily labor and equipment field reporting is required for accurate budget phase coding
        - Post completion job audit procedures should be performed – especially on contracts with significant profit fade or losses.

Davidson Construction Company, Inc. Chapter 3 **Exhibit A**

Uncompleted Contract Schedule

For the Period Ended 12/31/17

		1	2	3	4	5	6	7	8	9	10	11	12	13	14
				(1 - 2)	(3/1)		(1 x 12)			(6 - 7 - 8)	(6 - 5)	(5 - 6)	(8 / 2)	(2 - 8)	(3 - 9)
Job #	Description / Type / Location / Owner	Contract Amount	Total Estimated Cost	Estimated Gross Profit	Estimated Gross Profit Percentage	Billings to Date	Revenue Recognized	Accrued Loss	Cost to Date	Gross Profit to Date	Underbilling	Overbilling	Cost to Cost Percentage of Completion	Estimated Cost to Complete	Backlog Gross Profit
13022	Front end loaded job	20,000,000	16,000,000	4,000,000	20.00%	6,000,000	5,000,000	0	4,000,000	1,000,000	0	1,000,000	25.00%	12,000,000	3,000,000
	Nashville, TN; Dolly Partin Arena														
13032	Under-billed job	6,000,000	4,800,000	1,200,000	20.00%	4,200,000	5,000,000	0	4,000,000	1,000,000	800,000	0	83.33%	800,000	200,000
	Miami, FL; Shula's Steakhouse														
14002	Zero billed job	10,000,000	9,800,000	200,000	2.00%	0	1,224,490	0	1,200,000	24,490	1,224,490	0	12.24%	8,600,000	175,510
	Anchorage, AK; Goldmine														
14003	Substantially complete job	2,000,000	1,900,000	100,000	5.00%	1,900,000	1,947,368	0	1,850,000	97,368	47,368	0	97.37%	50,000	2,632
	Denver, CO; Elway Pizza Parlor														
14004	Loss Job	5,000,000	5,500,000	(500,000)	-10.00%	4,000,000	3,250,000	500,000	3,750,000	(500,000)	0	250,000	68.18%	1,750,000	0
	Nashville, TN; Vanderbilt Stadium														
14007	New job	1,000,000	850,000	150,000	15.00%	300,000	111,765	0	95,000	16,765	0	188,235	11.18%	755,000	133,235
	Nashville, TN; CMT studios														
15001	Davidson-Acme Joint Venture	80,000,000	72,000,000	8,000,000	10.00%	35,000,000	32,000,000	0	28,800,000	3,200,000	0	3,000,000	40.00%	43,200,000	4,800,000
	Seattle WA; Bill Gates Bridge														
	Less 40% attributable to Acme	(32,000,000)	(28,800,000)	(3,200,000)		(14,000,000)	(12,800,000)	0	(11,520,000)	(1,280,000)	0	(1,200,000)		(17,280,000)	(1,920,000)
	JV subtotal - 60% owned	48,000,000	43,200,000	4,800,000	10.00%	21,000,000	19,200,000	0	17,280,000	1,920,000	0	1,800,000		25,920,000	2,880,000
	Total Uncompleted Contracts	92,000,000	82,050,000	9,950,000	10.82%	37,400,000	35,733,623	500,000	32,175,000	3,558,623	2,071,858	3,238,235		49,875,000	6,391,377
									Net overbilling			1,166,377			

Davidson Construction Company, Inc.

Completed Contract Schedule

For the Period Ended 12/31/17

Job #	Description / Type / Location / Owner	Final Contract Revenue	Total Cost	Gross Profit (Loss)	Gross Profit (Loss) Percentage
13025	Completed job #1	20,000,000	18,300,000	1,700,000	8.50%
	Nashville, TN; Taylor Swift Theater				
13035	Completed job #2	25,000,000	25,200,000	(200,000)	-0.80%
	Miami, FL; Marino's Steakhouse				
14001	Completed job #3	17,000,000	15,691,000	1,309,000	7.70%
	Chicago, IL - Air Jordan Arena				
14005	Completed job #4	3,000,000	2,750,000	250,000	8.33%
	Tuscaloosa, AL - Tide Pizza				
	Total Uncompleted Contracts	65,000,000	61,941,000	3,059,000	4.71%

Davidson Construction Company, Inc.

Reconciliation of Contracts to Statement of Income

For the Period Ended 12/31/17

	Revenue Recognized	Total Cost	Gross Profit (Loss)
Completed contracts at 12/31/17 (job-to-date)	65,000,000	61,941,000	3,059,000
Uncompleted Contracts at 12/31/17 (job-to-date)	35,733,623	32,175,000	3,558,623
Idle equipment costs - unallocated - See Note 18		400,000	(400,000)
	100,733,623	94,516,000	6,217,623
Less revenue and cost recongnized thru 12/31/16	(19,293,609)	(17,881,489)	(1,412,120)
Statement of income - FYE 12/31/17	81,440,014	76,634,511	4,805,503

Davidson Construction Company, Inc.		Chapter 3	**Exhibit B**	***Adjusted to Historical Gross Profit Percentages***											
Uncompleted Contract Schedule															
For the Period Ended 12/31/17		1	2	3	4	5	6	7	8	9	10	11	12	13	14
				(1 - 2)	(3/1)		(1 x 12)			(6 - 7 - 8)	(6 - 5)	(5 - 6)	(7 / 2)	(2 - 7)	(3 - 8)
					Historical								Cost to Cost	Estimated	Backlog
		Contract	Total Estimated	Estimated	Gross Profit	Billings	Revenue	Accrued	Cost	Gross Profit			Percentage of	Cost to	Gross
Job #	Description / Type / Location / Owner	Amount	Cost	Gross Profit	Percentage	to Date	Recognized	Loss	to Date	to Date	Underbilling	Overbilling	Completion	Complete	Profit
13022	Front end loaded job	20,000,000	18,000,000	2,000,000	10.00%	6,000,000	4,444,444	0	4,000,000	444,444	0	1,555,556	22.22%	14,000,000	1,555,556
	Nashville, TN; Dolly Partin Arena														
13032	Under-billed job	6,000,000	5,400,000	600,000	10.00%	4,200,000	4,444,444	0	4,000,000	444,444	244,444	0	74.07%	1,400,000	155,556
	Miami, FL; Shula's Steakhouse														
14002	Zero billed job	10,000,000	9,500,000	500,000	5.00%	0	1,263,158	0	1,200,000	63,158	1,263,158	0	12.63%	8,300,000	436,842
	Anchorage, AK; Goldmine														
14003	Substantially complete job	2,000,000	1,900,000	100,000	5.00%	1,900,000	1,947,368	0	1,850,000	97,368	47,368	0	97.37%	50,000	2,632
	Denver, CO; Elway Pizza Parlor														
14004	Loss Job	5,000,000	5,500,000	(500,000)	-10.00%	4,000,000	3,250,000	500,000	3,750,000	(500,000)	0	250,000	68.18%	1,750,000	0
	Nashville, TN; Vanderbilt Stadium														
14007	New job	1,000,000	950,000	50,000	5.00%	300,000	100,000	0	95,000	5,000	0	200,000	10.00%	855,000	45,000
	Nashville, TN; CMT studios														
15001	Davidson-Acme Joint Venture	80,000,000	72,000,000	8,000,000	10.00%	35,000,000	32,000,000	0	28,800,000	3,200,000	0	3,000,000	40.00%	43,200,000	4,800,000
	Seattle WA; Bill Gates Bridge														
	Less 40% attributable to Acme	(32,000,000)	(28,800,000)	(3,200,000)		(14,000,000)	(12,800,000)	0	(11,520,000)	(1,280,000)	0	(1,200,000)		(17,280,000)	(1,920,000)
	JV subtotal - 60% owned	48,000,000	43,200,000	4,800,000	10.00%	21,000,000	19,200,000	0	17,280,000	1,920,000	0	1,800,000		25,920,000	2,880,000
	Total Uncompleted Contracts	92,000,000	84,450,000	7,550,000	8.21%	37,400,000	34,649,415	500,000	32,175,000	2,474,415	1,554,971	3,805,556		52,275,000	5,075,585
									Net overbilling			2,250,585			

Davidson Construction Company		Chapter 3	**Exhibit C**						
Contract Risk Analysis Worksheet									
For the Period Ended December 31, 2017		1	2	3	4	5	6	**7**	8
					(2-3)			**(5-6)**	(7/6)
			Estimated	Historical	Over (Under)	Gross Profit	Gross Profit	**Excess**	Materiality
		Contract	Gross Profit	Gross Profit	Gross Profit	Recognized	at Historical	**(Deferred)**	of Excess
Job #	Description / Type / Location / Owner	Amount	Percentage	Percentage	Percentage	To Date	Percentage	**Gross Profit**	(Deferred)
13022	Front end loaded job	20,000,000	20.00%	10.00%	10.00%	1,000,000	444,444	**555,556**	125.00%
	Nashville, TN; Dolly Partin Arena								
13032	Under-billed job	6,000,000	20.00%	10.00%	10.00%	1,000,000	444,444	**555,556**	125.00%
	Miami, FL; Shula's Steakhouse								
14002	Zero billed job	10,000,000	2.00%	5.00%	-3.00%	24,490	63,158	**(38,668)**	-61.22%
	Anchorage, AK; Goldmine								
14003	Substantially complete job	2,000,000	5.00%	5.00%	0.00%	97,368	97,368	**0**	0.00%
	Denver, CO; Elway Pizza Parlor								
14004	Loss Job	5,000,000	-10.00%	-10.00%	0.00%	(500,000)	(500,000)	**0**	0.00%
	Nashville, TN; Vanderbilt Stadium								
14007	New job	1,000,000	15.00%	5.00%	10.00%	16,765	5,000	**11,765**	235.29%
	Nashville, TN; CMT studios								
	Total Uncompleted Contracts	44,000,000	10.82%	8.21%	2.61%	1,638,623	554,415	**1,084,208**	195.56%
			Net overbilling - based on estimated gross profit %					$ 1,166,377	
			Net overbilling - based on historical gross profit %					2,250,585	
			Net impact to working capital and gross profit (pre-tax)					$ (1,084,208)	
						% of Revenue		1.43%	
						% of Gross Profit		28.53%	
						% of Equity		21.68%	

Davidson Construction Company			Chapter 3		**Exhibit D**		
Front-End Loading to Overbilling Analysis							
December 31, 2017		(1)	(2)	(3)	(4)	(5)	(6)
					Pro-Rated		Front-End
		Mobilization			Front-End		Surplus
Contract		Front-End	%	%	Loading	Overbilling	(Deficit)
#	Description	Loading*	Complete	Uncompl.	(1) x (3)	Reported	(5) - (4)
Grading Division							
G1	Grading Contract						
	Tennessee DOT Z001	$ 300,000	90.0%	10.0%	$ 30,000	$ -	$ (30,000)
G2	Grading Contract						
	Tennessee DOT Z002	1,000,000	60.0%	40.0%	400,000	100,000	(300,000)
G3	Grading Contract						
	Tennessee DOT Z005	400,000	30.0%	70.0%	280,000	300,000	20,000
G4	Grading Contract						
	Tennessee DOT Z006	240,000	20.0%	80.0%	192,000	250,000	58,000
		1,940,000			902,000	650,000	(252,000)
Asphalt Paving Division							
P1	Paving Contract						
	Tennessee DOT Z009	50,000	80.0%	20.0%	10,000	25,000	15,000
P2	Paving Contract						
	Tennessee DOT Z010	200,000	50.0%	50.0%	100,000	50,000	(50,000)
		250,000			110,000	75,000	(35,000)
Bridge Division							
B1	Bridge Contract						
	Tennessee DOT Z011	1,000,000	55.0%	45.0%	450,000	200,000	(250,000)
B2	Bridge Contract						
	Tennessee DOT Z012	100,000	10.0%	90.0%	90,000	50,000	(40,000)
		1,100,000			540,000	250,000	(290,000)
		$3,290,000			$1,552,000	$ 975,000	$ (577,000)

* Mobilization and front-end load amounts obtained from schedule of values and bid documents.

At a minimum, contracts should have a front-end **surplus**. In addition to a front-end surplus, each contract must have an overbilling reserve sufficient to cover contract completion, punch list, collection reserves, etc. Front-end deficit indicates significant risk that POC estimates may be incorrectly optimistic.

Reasonable support for front end load deficit include the following:
1. Surety bond or special insurance deposit
2. Front-end payments to subcontractors or supplier
3. General conditions, jobsite set-up, etc.

Auditor should obtain evidential matter to support front-end billing deficit.

Chapter 3 **Exhibit E**

Homebuilder Company, LLC
Uncompleted Contract Schedule
For the Period Ended 12/31/17

#	Owner/Address/type	1 Contract Amount	2 Total Estimated Cost	3 (1 - 2) Estimated Gross Profit	4 (3/1) Estimated Gross Profit Percentage	5 Billings to Date	6 (1 x 12) Revenue Recognized	7 Cost to Date	8 (6 - 7) Gross Profit to Date	9 (6 - 5) Underbilling	10 (5 - 6) Overbilling	11 (7 / 2) Cost to Cost Percentage of Completion	12 (2 - 7) Estimated Cost to Complete	13 (3 - 8) Backlog Gross Profit
111	Green Hills - Davidson Home	1,000,000	900,000	100,000	10.00%	900,000	666,667	600,000	66,667	0	233,333	66.67%	300,000	33,333
	Single family residence													
114	Donelson - Merrill Home	450,000	400,000	50,000	11.11%	450,000	427,500	380,000	47,500	0	22,500	95.00%	20,000	2,500
	Single family residence													
115	Hillwood - Cash Home	1,200,000	900,000	300,000	25.00%	1,000,000	1,080,000	810,000	270,000	80,000	0	90.00%	90,000	30,000
	Single family residence													
119	Liepers Fork - Urban Home	1,800,000	1,600,000	200,000	11.11%	1,500,000	1,350,000	1,200,000	150,000	0	150,000	75.00%	400,000	50,000
	Single family residence remodel													
120	Franklin - Brooks Home	100,000	80,000	20,000	20.00%	0	30,000	24,000	6,000	30,000	0	30.00%	56,000	14,000
	Home improvements													
	Total Uncompleted Contracts	4,550,000	3,880,000	670,000	14.73%	3,850,000	3,554,167	3,014,000	540,167	110,000	405,833		866,000	129,833

Net overbilling	295,833

Homebuilder Company, LLC
Completed Contract Schedule
For the Period Ended 12/31/17

#	Description / Type / Owner	Final Contract Revenue	Total Cost	Gross Profit (Loss)	Gross Profit (Loss) Percentage
112	Smithville - Stone lake home	660,000	540,000	120,000	18.18%
	Single family vacation home				
113	Belle Meade - Gill residence	1,000,000	860,000	140,000	14.00%
	Single family home				
116	Brentwood - Paisley home	1,575,000	1,275,000	300,000	19.05%
	Single family residence				
117	Sylvan Park - Harris townhome	600,000	725,000	(125,000)	-20.83%
	Townhome - duplex				
	Miscellaneous warranty/renovation	145,000	142,000	3,000	2.07%
	Total Uncompleted Contracts	3,980,000	3,542,000	438,000	11.01%

Homebuilder Company, LLC
Reconciliation of Contracts to Statement of Income
For the Period Ended 12/31/17

	Revenue Recognized	Total Cost	Gross Profit (Loss)
Completed contracts at 12/31/17 (job-to-date)	3,980,000	3,542,000	438,000
Uncompleted Contracts at 12/31/17 (job-to-date)	3,554,167	3,014,000	540,167
	7,534,167	6,556,000	978,167
Less revenue and cost recongnized thru 12/31/16	(3,100,000)	(2,850,000)	(250,000)
Statement of income - FYE 12/31/17	4,434,167	3,706,000	728,167

Homebuilder Company, LLC
Speculative (Spec) Construction/Development in Progress Schedule
For the Period Ended 12/31/17

		Projected Sale Price at Completion	Projected Total Cost at Completion	Land Cost	Construction in Progress	Total Inventory	Estimated Completion Date	Bank Loan Balance	Net Equity
*	Single family residence - 10,000 s.f. - Natchez	1,800,000	1,385,000	-	10,000	10,000	12/31/18	-	10,000
	Single family residence - 8,000 s.f. - Franklin	1,400,000	1,250,000	525,000	675,000	1,200,000	Complete	1,200,000	-
	Multi-family town home - 1727 2nd Ave. Unit 1	625,000	560,000	100,000	60,000	160,000	04/30/18	100,000	60,000
	Multi-family town home - 1727 2nd Ave. Unit 2	625,000	560,000	100,000	40,000	140,000	05/31/18	100,000	40,000
	Single family residence - 2,000 s.f. - Murphy Rd.	1,350,000	1,150,000	300,000	350,000	650,000	09/15/18	500,000	150,000
	Total construction in progress - spec projects	5,800,000	4,905,000	1,025,000	1,135,000	2,160,000		1,900,000	260,000

* Land was purchased on 1/10/18 for $500,000

Contract Cost Shifting				Chapter 3	Exhibit F								
Illustration													
FYE	12/31/2018	1	2	3	4	5	6	7	8	9	10	11	12
				(1 - 2)	(3/1)		(1 x 11)		(6 - 7)	(6 - 5)	(5 - 6)	(7 / 2)	(2 - 7)
					Estimated							Cost to Cost	Estimated
		Contract	Total Estimated	Estimated	Gross Profit	Billings	Revenue	Cost	Gross Profit			Percentage of	Cost to
Job #	Description	Amount	Cost	Gross Profit	Percentage	to Date	Recognized	to Date	to Date	Underbilling	Overbilling	Completion	Complete
Actual contract costs													
Contract in Progress													
1801	Sam's Building	10,000,000	8,000,000	2,000,000	20.00%	6,000,000	5,000,000	4,000,000	1,000,000	0	1,000,000	50.00%	4,000,000
Complete													
1802	Costco Building					22,000,000	22,000,000	22,000,000	0				
						28,000,000	27,000,000	26,000,000	1,000,000	0	1,000,000		
After cost shifting													
Assume cost shift - Move $1 million of cost from Costco (completed job) to Sam's (Uncompleted job)													
Contract in Progress													
1801	Sam's Building	10,000,000	8,000,000	2,000,000	20.00%	6,000,000	6,250,000	5,000,000	1,250,000	250,000	0	62.50%	3,000,000
Complete													
1802	Costco Building					22,000,000	22,000,000	21,000,000	1,000,000				
						28,000,000	28,250,000	26,000,000	2,250,000	250,000	0		
		Material Misstatements - Increase (Decrease)				0	1,250,000	0	1,250,000	250,000	(1,000,000)		

Chapter 4 - Contractor Internal Controls and Best Practices

Contractor Internal Control Checklist

1. Obtain background and credit report on new employees.
    a. Especially if employee relocated from another State
    b. Employee knowledge and signature required
    c. Approximate cost is $300; “FBI type” report cost is $2,000

2. Check signing process is important – electronic or manual.
    a. Dual signatures are recommended; accounting personnel with access to check disbursement process should never sign.
        1) CFO should be locked out of check preparation if signer.
    b. Authorized check signer should control check signing machine plates or computer signature codes. The employee that produces the check should NOT have access to computer signature authorization.
    c. Signer (or final check reviewer) must have documentation as check is signed. Information should be spot-checked for authenticity and approval procedures. Signing a “stack” of checks is bad.
    d. Scanners have created a whole new world for fraud – concern for duplicate payment of scanned invoices – and alteration. System should protect against altered vendor invoice numbers to avoid duplicate payment.
    e. Meet with bank to develop separation of duties and controls for ACH and cash transfers
    f. Assign “areas of responsibility” for check signers to prevent “ignorant signature shopping” – A/P clerk will always go to least attentive check signer
    g. Emergency checks should be scrutinized carefully. Avoid “manual” checks that are not produced in the computer
    h. All contractor should use “positive pay” system

3. Bank statements and cancelled checks should be reviewed monthly by management personnel independent of check preparation and signing process:
    a. Altered checks – payee and / or amount.
    b. Electronic transfers and inter-company transfers
    c. Forged or unauthorized check signatures
    d. Unusual payee and/or endorsement
    e. Signs of altered payee or amount
    f. Duplicate checks to same payee and same amount
    g. Create a fear that you will review every check

4. Cash receipts and deposit function
    a. Controller or A/R clerk should never pick up mail or make bank deposit. Never. Anyone with access to billing and accounts receivable cannot handle incoming checks.
    b. Lock box and electronic payment should be used if practical.

c. Mail clerk should prepare a manual (Excel) deposit log. Logs should be protected from destruction or tampering. Logs should be used to verify deposit accuracy. Checks should be copied.
d. Check scanning deposit process (if utilized) should be performed by person independent of A/R or Billing.
e. Review aged receivable list monthly.
f. Perform a proof of cash reconciliation at least once per year. Compare total deposits with total credits in A/R.
g. Billing and A/R clerks must be "locked out" of journal entries to credit Customer A/R

5. Job Site and Plant Controls
   a. Job quantities should be calculated in initial estimate. Actual quantities used should be entered in the job cost system and compared to estimated quantities. Material variances should be investigated.
   b. Loss jobs should be scrutinized. Any job that performed poorer than expected should be evaluated. Why?
   c. Plant sales profits below expectations should be scrutinized.
   d. Consider a cash "bait" test. Hire a trucker to purchase a load of asphalt or aggregate for cash. Look for the cash to be deposited with that day's receipts.
   e. Investigate any missing ticket number on a monthly basis.
   f. Plant scales should be "on-line" with billing system to prevent deletion of ticket by scale operator.

6. Labor controls
   a. Daily time sheets are mandatory – prevent 10-10-10 phenomenon.
      1) Use I-pad type reporting system
      2) Consider face recognition or finger print check-in
      3) Consider time bar code system at plant and job sites for better phase coding.
   b. Occasionally perform a surprise payroll check off. Deliver checks to job or plant site and personally hand out checks. Investigate "missing" employees.
   c. Use direct deposit or smart cards instead of payroll checks.
   d. Consider bonus based on labor budget savings.
   e. Review cancelled payroll checks returned with bank statement.
   f. Someone independent of payroll clerk should trace electronic tax deposits to tax returns
   g. Utilize E-Verify system properly – no exceptions
   h. Payroll clerk should be "locked out" of creating new employee or changing rates without HR approval process (separation of duty)
   i. Comply with retirement plan timely deposit rules

7. Subcontractor management and controls

   a. Implement a subcontractor prequalification process
      1) Utilize subcontractor prequalification form
      2) Obtain financial statement and credit report annually on major subs (unless bonded)
      3) Obtain safety experience mod information
      4) “We have used this subcontractor for years, without a problem” is not adequate internal control
   b. Utilize a written subcontractor bonding process
      1) For example, all subs over $500k or based on type of work
      2) Validate the surety bond authenticity when received
      3) Utilize payment lock out until bond received
      4) Does the Company use SDI – Subcontractor Default Insurance – also known as “Sub-Guard Insurance”?
   c. Verify authenticity of certificate of insurance and “named insured”
      1) Utilize payment lock-out for expired insurance date
      2) Determine if company is “named insured” on policy
   d. Develop approval process for:
      1) “Too low” sub quote
      2) Use of “non-low” sub quote
      3) Obtaining fewer than 3 sub quotes
   e. Develop and implement monthly procedure to verify subcontractor payment of suppliers prior to release of monthly check to sub:
      1) Obtain list of subcontractor suppliers and contact information
      2) Send monthly email to major suppliers to verify payment through prior month pay request
      3) Inform supplier to request joint check if payment is delinquent
   f. Verify Subcontractor DBE compliance
      1) Have bidding and project management personnel been adequately trained regarding DBE laws and Company policies?
      2) Are subcontractors used to perform “non-commercially useful” functions?
      3) Are joint checks issued to DBE subcontractors without DOT approval?
      4) Are Company materials or equipment provided to DBE and inappropriately included in the DBE %?

8. Payments to subs and truckers are vulnerable to errors and fraud.

   a. Subcontractor and trucking disbursements are occasionally calculated internally – this removes an element of control. Overpayment will rarely result in a voluntary refund.
   b. Payments should be reconciled to original subcontract agreement schedule of values and hauling quotes.
   c. Quantities should be entered and reconciled at the completion of contract to paid quantities. For example, tons of stone hauled should agree to tons purchased and billed.
   d. If practical, independent personnel should be assigned control over subcontracts and truckers.

9. Bidding and Estimating Controls

a. Design and utilize a comprehensive owner/project prequalification form.
   1) Completed form should be reviewed and approved by management before submission of bid and/or signing contract
   2) Obtain certificate of financing and credit report for private projects
b. Has the contractor adopted the "Bid/Build/Collect" bidding and project management process?
   1) Or is "bid-handoff model" still untilized?
   2) Note: bid-build-collect process involves PMs from inception prior to bidding. Bid-handoff process does not involve PMs until bid is submitted.
c. Are personnel adequately trained on estimating software?
d. If Excel bidding template used, are controls in place to prevent over-riding formulas and calculations?
e. How long have estimators been employed by the contractor? Any recent turnover or retirements?
f. Scrutinize and monitor social, family or other relationships with suppliers, subcontractors or other vendors and Company estimators and PMs.
   1) Are relationships documented and monitored annually?
   2) Does CFO look for unusual trends?
   3) Does the contractor have a policy prohibiting travel, entertainment and "gifts" to estimators and project managers?
   4) Suppliers and subcontractors should be notified about company policy prohibiting "soft" kickbacks without approval.
g. Prior to submission of bid to owner:
   1) Estimate must be reviewed and approved by a 2nd person for financial accuracy.
   2) Estimates on contracts above $xxx,xxx must be reviewed and approved by management.
   3) Contract estimating files should be reviewed periodically to verify that multiple quotes were obtained for significant subcontractors, suppliers and vendors. Company policy should be followed.
   4) Management must approve of utilization of non-low quotes?
   5) Management must approve use of very low quotes?
   6) Management must approve non-bonded subs and suppliers?
h. Are standard labor rates and related burden rates updated in the bidding software regularly?
i. What policies and procedures are in place to protect the company from significant price increases from material suppliers post-bid?
   1) Are escalator clauses included in contracts?
   2) Does the company obtain fixed price quotes supported by supply bonds?
   3) Does the company purchase hedge contracts? If so, are hedge contracts purchased for correct quantities and maturity dates to offset contract material purchases?

j. Are transfer prices for plant costs reviewed and approved prior to bid?
k. Are estimators prohibited from telephone and email usage during last few hours of bid preparation process?
l. Management should review the vendor list quarterly and investigate any unknown or suspicious vendors.
   1) New vendors must be approved prior to entry into A/P system.
m. Estimators and PMs must work with accounting personnel in conversion of bid pay items to phase code job cost budgets.
n. Are estimators provided bid to actual results on a monthly basis to validate the accuracy of prior bids and learn from bid mistakes and errors?
   1) Fade / gain analysis schedules should be sorted by estimator, PM, job superintendent, contract type, customer, etc.
o. Implement a post-completion job audit review process.
   1) Target under-performing or loss contracts
   2) Compare original bid quantities to actual quantities purchases and final quantities paid by owners (DOT)
   3) Compare original bid prices from subs and vendors with actual paid invoices
   4) Discuss potential unpaid quantities or change orders with PMs and job site superintendents
   5) Reconcile quantities paid to subcontractors with final quantities paid by owner
      a. Scrutinize contract items split between multiple subcontractor or self-performed by Company
   6) Review phase codes with significant variances
   7) Reconcile final pay application (DOT estimate) with deposits
   8) Review final DBE reports and reconcile to pay items
      a. Report errors or inaccuracies to DOT promptly
   9) Review certified payrolls – Company and Subcontractors

10. Travel & entertainment expenses
   a. Internal controls should require an expense report to document the business purpose for travel, meals and entertainment.
   b. If per diem travel reimbursement is utilized, adhere to IRS reporting rules.
      1) Meals portion is 50% non-deductible unless reimbursement required by contract
      2) Meals are 40% of per diem if lower amount used.
   c. Do not allow employees to purchase company supplies and pay expenses on personal credit cards for the “miles”.
   d. Special scrutiny should be applied to officer’s and accounting personnel credit cards and expense reports. Missing monthly reports are an issue.
   e. For Companies with multiple shareholders, recommend an appropriate approval process.
   f. Spouse travel and vehicle costs are a potential IRS risk.

g. Implement a written company vehicle policy.
    1) Company owned vehicles
    2) Employee owned vehicles (monthly allowance policy)
h. Take note of special tax rules applicable to high-risk areas: boats, country clubs, airplanes, sky boxes (now non-deductible), etc.

11. Other internal control recommendations
    a. Use Shredders – don't underestimate the danger.
    b. Verify fidelity insurance coverage (at least $500,000 w/ $25,000 deductible). Coverage should include job and plant sites.
    c. Use lock-out software functions to limit access to certain files
    d. Perform a review of computer security procedures, passwords, etc. regularly.
    e. Maintain separation of duties for key functions during employee vacations and absences.
    f. Consider internet monitoring software – and email training.
    g. Senior management and owner should have all employee passwords for company files and systems.

Contractor Best Practices

Vehicle Allowance – Sample Policy

Davidson Construction Company Responsibilities:

1. Operate the plan under IRS rules and regulations which allow for the non-taxable treatment of vehicle reimbursements for participants who comply with monthly business mileage reporting requirements. The total annual vehicle allowance must not exceed the business mileage submitted for the full year at the applicable IRS reimbursement rate. (Currently 53.5 ¢ per mile. If gas card is provided, non-taxable mileage is limited to 40 ¢ per mile.)

2. Pay the employee a fixed monthly vehicle allowance amount of $_________ on or before the 5th day of each month via direct deposit or manual check.

3. Provide a Company fuel credit card to the employee with will require input of the vehicle odometer reading at the time of purchase. Fuel purchases are allowable for the designated business vehicle only. Employee will be required to reimburse the Company for fuel charges in excess of reasonable mpg calculation.

4. Include any taxable income on the employee's annual Form W-2 for any amounts paid in excess of IRS non-taxable calculation.

Employee Responsibilities:

1. Provide proof of insurance with an A-rated company demonstrating minimum coverage limits of $300,000/$300,000/$100,000. An insurance card stipulating the limits must be submitted to the Davidson Construction risk manager with an expiration date of not less than 6-months. Consider adding company as "named insured" with insurance carrier to receive direct notice of extension or cancellation.

2. Vehicles must not be older than five (5) model years and must meet minimum standards for safety and operating condition. Tires, brakes, lights and similar items must be in good operating condition. The vehicle must be a ½ ton or larger pickup truck with undamaged body and appropriate exterior paint color. No bumper stickers or controversial/political messaging will be allowed on the vehicle.

3. Monthly mileage reports detailing daily jobsite and other business travel must be submitted by the 1st day of each month to receive payment. The preferred procedure is to e-mail the mileage report to Human Resources on the Excel template provided. Allowance payments will be withheld if insurance cards are not on file or mileage is not submitted by the 1st of each month.

4. Employee must adhere to drug and alcohol policies included in the employee handbook at all times while operating the vehicle.

I have thoroughly read and understand the Davidson Construction vehicle allowance policy.

_________________________________ ________________

Employee Date

DBE Subcontract Compliance – Heavy / Highway Contractors
5 Most Common Mistakes

1. **Materials purchased from the Prime Contractor or its Affiliates are improperly included in the DBE subcontract participation amount.**
    a. The Prime Contractor cannot re-purchase their own materials previously sold to the DBE Subcontractor and include the payment toward the DBE goal. This practice is not a commercially useful function.
    b. Materials sold by the prime to the DBE subcontractor must be excluded from the DBE participation certification.
    c. This prohibition applies to materials provided to the DBE by any affiliated entity with common ownership.
    d. Joint checks issued by the Prime Contractor to the DBE Subcontractor and the Prime Contractor or Affiliates cannot be reported as a DBE expense.
2. **Materials purchases that are negotiated and procured by the Prime Contractor are improperly "run-through" the DBE Subcontractor to inflate the DBE participation amount.**
    a. The DBE Subcontractor is not in the "ordinary trade or business" to sell the materials and does not regularly sell the materials to other contractors or consumers. Qualification as a commercially useful function is doubtful.
    b. The personnel of the Prime Contractor improperly negotiated the price and terms of the materials from the non-DBE supplier and orchestrated the use of the DBE Subcontractor as the intermediary. The invoices, quotes and email communications clearly indicate the true source of the purchase order.
    c. The materials purchased are paid by joint check payable to the DBE Subcontractor and the non-DBE supplier.
    d. The DBE Subcontractor is, in fact, providing delivery services only.
3. **Equipment or trucks owned by the Prime Contractor or its Affiliates are rented to the DBE Subcontractor and improperly reported as expenditures toward the DBE participation goal.**
    a. A DBE Subcontractor is prohibited from including the expense for trucks or equipment rental paid to the Prime Contractor as qualified DBE goal expenditures.
    b. Truck rental or equipment rental payments from the DBE Subcontractor to the Prime Contractor must be excluded from the DBE Participation Certification.
    c. This prohibition applies to all trucks or equipment rented to the DBE by any affiliated entity with common ownership.
4. **The DBE Subcontractor improperly engages a non-DBE subcontractor to provide or perform a significant amount of work items on the contract.**
    a. The DBE Subcontractor must perform a commercially useful function on the jobsite for a substantial portion of the subcontracted work. At least 30% must be performed with the DBE's own workforce.
    b. The DBE must not use "temporary" personnel or supervisors provided by another non-DBE subcontractor, the Prime Contractor or its affiliates.
    c. It could be a red flag if the DBE Subcontractor has no prior experience or expertise to perform the pay items with their own personnel
    d. The Prime Contractor's jobsite personnel are aware that the DBE's own personnel are not performing or supervising the work. Instead, it is apparent that a 3rd-tier non-DBE Subcontractor is performing the work.

    e. Note: Non-DBE Prime Contractors are prohibited from performing services for DBE Subcontractors which are fraudulently reported toward the DBE goal. Non-DBE contractors should refrain from quoting DBE contractors for work that will clearly violate the intent of the DBE goal.

5. **The Prime Contractor conducts business with primarily one DBE Subcontractor giving the appearance of a "captive DBE relationship".**
    a. The Prime Contractor does not maintain an appearance of an "arms-length" relationship with the DBE Subcontractor.
    b. Evidential matter (email communications, quotes and letters) indicates that the prices and terms of the pay items are dictated to the DBE Subcontractor by the Prime Contractor.
    c. The Prime Contractor or their personnel improperly provide accounting, bookkeeping or administrative services to the DBE.
    d. The Prime Contractor improperly "nets the check" payable to the Subcontractor by improperly deducting back charges and services
    e. The Prime Contractor has provided loans or other financial support to the DBE subcontractor with terms and conditions that indicate an improper exercise of control. For example, the loan is due on demand and accrues interest at an annual rate of 20%.

Other Recommendations for Proper DBE Compliance

1. Joint checks should only be issued if requested in writing from the DBE Subcontractor's supplier.
    a. If the check payment to a DBE Subcontractor is "netted" with offsets for back charges and deductions, only the net check amount is eligible to be included in the DBE goal certification
2. Obtain financial information on the DBE Subcontractor, including:
    a. Financial statements and tax returns
    b. Credit report and bank references
    c. Certificates of insurance, worker comp rating and surety bond credit, if any
    d. Resume of owner and key personnel
    e. Documentation of DBE certification and contractor licensing
3. Provide company-wide DBE compliance training on an annual basis – discuss:
    a. Company policy and procedures for DBE Subcontractor termination and replacement - including owner notification
    b. Prohibited practices and procedures
    c. Policies and procedures regarding submission of quotes to perform work for DBE set-aside projects and DBE subcontracts
    d. Joint check and net-check policies and procedures
    e. Elimination of inappropriate and insensitive email communication
    f. Expenditures that should be disallowed and not reported as DBE participation
    g. List of Company approved and recommended DBE subcontractors
    h. Consider DBE development and training seminars

Contractor Per Diem Reimbursement Plan

Travel and Per Diem Expense Reimbursement Overview

1. Per Diem method allows deduction for company and no taxable income for employee
   - A. Employers can reimburse employee travel costs at one per diem rate for high-cost areas in the U.S. and another rate for all other areas.
   - B. Allowable Per Diem Rates for 12/31/2017

	High-Cost Location	Non High-Cost
Lodging rate	$216	$134
Meals & Incidentals	68	57
Combined per diem	$242	$163

   - C. Employer can chose to use the Per Diem rate to reimburse for Meals and Incidentals only.
   - D. IRS does not allow employers to reimburse for just the Lodging per diem portion of the rate.
   - E. Employer can either reimburse or pay actual lodging expenses for employees
   - F. Employee is expected to be able to substantiate overnight travel
   - G. If paying per diem less than total amount, the IRS treats 40% as meals (50% disallowed for tax)

   Note: If a job extends for more than one year, all per diem or expense reimbursements will be treated as personal living expenses and taxable to the employee.

2. Example

   Construction company pays per diem for out of town travel vs. "Out of Town wage bonus"
   Can pay up to the limits ($284 High-cost or $191 Low-cost).

	Out of town wage bonus	Per Diem Reimbursement	Savings
Paid to Employee	$ 150.00	$ 150.00	
Actual Lodging Exp.	(50.00)	(50.00)	
Net	100.00	100.00	
Income tax (20%)	(20.00)	-	
Payroll tax on wages	(7.65)	-	
Employee	$ 72.35	$ 100.00	$ 27.65
Paid by Company	$ 100.00	$ 100.00	
Burden (WC, GL, etc.)	22.00	-	
Payroll Tax (FICA)	7.65	-	
Total Expense	$ 129.65	$ 100.00	$ 29.65
Meals & Ent. disallowance	-	(30.00)	
Deductible for tax	129.65	70.00	
Tax Deduction @ 34%	(44.08)	(23.80)	$ (20.28)
Employer	$ 85.57	$ 46.20	$ 9.37
Net Savings to Employer and Employee - per day			$ 37.02

3. Summary of Total Savings - Example

Assume 50 employees; 200 day job	Employees on job	50
	200 working days	200
		10,000
		$ 9.37
Total Company (employer) savings		$ 93,690
Each employee additional compensation (200 days @ $27.65)		$ 5,530

Acme Construction Co.
Supplemental Pay Request - Per Diem Notification

To: Tennessee Department of Transportation
Date: 12/31/17
Contract No. I65256JW
Giles - Lincoln Counties
Pay Estimate #26

In accordance with contract provisions 27.1(a) and 27.2(a), Acme Construction Co. hereby submits the following information as a supplement to the standard TDOT pay estimate. In compliance with the provisions of the contract, Acme paid the following per diem reimbursement for lodging, meals and incidentals;

	Per diem Lodging	Per Diem Meals	Per Diem Total
Per diem rate - required by contract	$ 60.00	$ 40.00	$ 100.00
Number of employees x qualified travel days	880	880	880
	$ 52,800.00	$ 35,200.00	$ 88,000.00

The per diem amounts were submitted to TDOT for reimbursement as part of the unit prices for items 13.0 through 22.0, items 46.0 through 48.5 and items 141.0 through 155.0.

In accordance with the requirements of IRS Code Section 274, Acme hereby confirms to TDOT that the per diem amounts above were paid to employees in compliance with an expense reimbursement requirement of the contract. Furthermore, Acme Construction has obtained satisfactory support to substantiate the over night travel for each employee in accordance with IRS regulations.

Accordingly, Acme Construction will deduct 100% of the meals and incidental amount as paid on behalf of TDOT, the contact owner.

Acme Construction Company
Subcontractor Prequalification Form

Subcontractor Name: ____

Mailing Address: ____

Physical Address: ____

Subcontractor Company Owner & Key Contact Person: (Name, Title, Phone, email, etc.)

____

____

____

Telephone: _______________________Email: __________________________

Website: ____

Contractor License No.: __________ Limitation: __________________________

If applicable: DOT prequalification limit: ____________________________

DBE certification: ___________________________________

License, prequalification & DBE status verified with State by: ______________

References:

____

____

Repeat Subcontractor of Acme? Yes________ No________
If yes, explain prior experience (performance, payment, DBE, bonding, safety, etc.):

____

____

____

Acme subcontractor prequalification policy requires the Project Manager to obtain the following information annually <u>prior to accepting bid prices from Subcontractor:</u>

Project Manager must check each procedure when completed:

- ☐ Obtain a letter from the subcontractor's surety verifying the single job and aggregate bonding limitations. Letter should include:
    - Single job limit $______________ Aggregate limit $______________
    - Surety name: ____
    - Surety rating: ________________

- ☐ Obtain an audited or reviewed balance sheet from the subcontractor. The financial statements should be transmitted to Acme CFO and accounting department for analysis. If the bonding letter is obtained, the requirement for obtaining a financial statement can be waived with Management approval. Certain subcontractors are sensitive to providing financial statements.

- ☐ Obtain a written credit report on the subcontractor and related entities.
    - Issues ____
    - Attach copy of report

- ☐ Obtain a list of projects completed by the subcontractor in the past 3 years. List should include location, description, owner, contract amount, type of work, owner, name and phone number of contact person

- ☐ If new subcontractor, contact at least 3 owner references from the completed project list. Attach memo reporting conversation with owner references.

- ☐ Obtain insurance information:
    - Insurance agency: ____
    - Insurance company: ______________________________________
    - Worker comp safety mod %: ________________________________
    - Umbrella coverage amount: $_______________________________

- ☐ Obtain names and contact information from 3 suppliers / vendors to the subcontractor on completed projects. Contact suppliers and inquire about past payment experience and current credit limits.

- ☐ Other procedures and comments:

Acme bidding control procedures require the following information and procedures prior to accepting and submitting bids from the Subcontractor. Project Manager must complete the following procedures for each bid prior to inclusion of subcontractor's pricing:

☐ Obtain written verification directly from surety representative (not agent) that subcontractor is able to provide surety bond from A-rated surety if contract is awarded. Letter should include maximum range of subcontract quote.

☐ If surety letter is not obtained, financial statement must be provided and analyzed by CFO. If financial ratios are adequate, discuss key provisions to be included in subcontract agreement in consideration of non-bonded subcontract:
  - Increased retainage amount (if permissible)
  - Verification of supplier payment prior to release of check
  - Joint check payment to major suppliers
  - Lien release verification from suppliers
  - Personal guaranty from subcontractor owners
  - Cash collateral from subcontractor

☐ Waiver of surety bond requirement must be obtained from management / owner and approved with signature below.

☐ Obtain certificate of insurance verifying coverage required by contract owner.

☐ Obtain list of major suppliers for this contract – include contact information.

☐ If subcontractor is DBE, obtain an understanding of DBE compliance regarding self-performance of work and related regulations.

☐ Amount of bid spread between low quote and 2nd quote: $ _______________
  - If more than 10%, consider liability to Company if sub cannot perform.

☐ Maintain a professional business attitude during this process. Remember – treat the subcontractor with respect and appreciation. However, consider the risk to the Company if the subcontractor failed to perform or pay vendors.

☐ Other procedures or comments: ____
____

<u>Attach documentation of prequalification information to this form.</u>

<u>Signatures:</u>

Project Manager: ____ Date ____________

Approved by CFO: ____Date ____________

Best Practices of a Construction Company CFO

1. **Understand Construction Accounting**
   Percentage of completion method
   Job costing principles
   Unique financial reporting and disclosure requirements
2. **Understand Construction Taxation**
   Available methods (cash, accrual, CCM, POC)
   Code Section 460 – Special Rules for Long-Term Contracts
   Contract exemptions from 460 – identify on WIP schedule
   Lookback principles and calculation
   Like-kind exchange rules – sales tax savings
   Depreciation methods; repair capitalization
   Multi-state taxation (sales tax, gross receipts tax, payroll tax)
3. **Perform Construction Financial Analytics**
   Percentage of completion contract schedules
   "Underbilling is not normal; overbilling should be in the bank"
   Contract fade / gain analysis
   Bid spread analysis
   Surety and banking ratios
   Industry averages and benchmarks
4. **Understand the Importance of Cash**
   Convert contract schedules to cash basis
   Create incentives to improve contract cash position
   Prepare backlog cash flow schedule
   Stored materials clauses
   Retainage reduction and/or substitution clauses
   Billing cycle management
   Cash management is NOT holding subs money
5. **Understand and Participate in the Bidding Process**
   Cash flow needs of the job
   Prequalification of owner (certificate of financing, D & B, etc.)
   Implement internal control procedures for bidding and estimating:
      Multiple quotes required
      Confidentiality
      Mathematical accuracy
      Bidding software or templates
   Prequalify subcontractors (bonded, retainage, etc.)
   Licensing and prequalification limits
   Maintain database of previously bid jobs
   Analyze bid spread
   Prepare and create budget based on bidding (consider front end loaded items)
   Bonding requirements
   Tax rates, registration in new geographical area

6. Create and Maintain an Internal Control Environment

Job costing procedures and principles

- Lock out project managers to prevent cost shifting
- Create practical phase code system
- Implement and monitor accurate indirect cost allocation system

Subcontract costing and management

- Prequalification requirements
- Certificates of insurance – verification and notice of renewal
- Verification of surety bond prior to work order
- Lien release documentation
- Communication with major suppliers

Job site controls

- Daily labor reporting by phase code
- Equipment hours reporting
- Contract billing controls
- Cutoff / matching principle
- Monthly billing meeting with project managers
- Change order management

7. Be a Player – Not an Historian

Know the jobs
Know the project managers and superintendents
Assist in bidding process
Provide proactive analysis and advice
Money is made in the field – go there regularly

8. Timeliness

Monthly reporting by the 25th or sooner
Quarterly analytical procedures
Extensive pre-year end planning

- What if scenarios – bonding, banking, tax

Annual audit report issued 8-10 weeks after year end
Licensing and prequalification

9. Create a Great Financial Team

Banker that understands the industry
Bonding / insurance agency that works for you
Surety – Do you have the right one for your niche, size and location?
CPA firm with construction expertise that adds value
Attorney specialist in contract law and construction litigation

10. Honesty

Integrity pays off
Construction is a risky business; knowing the truth early is vital
Surety relationship is destroyed by lack of trust

Chapter 5 - Construction Company Valuations
Strategies & Considerations - 2018

Valuation Overview

1. Current Trends and Observations
   a. In 2018, valuation methods and calculations are nearing the 2005 peak
      - Buyers and valuation experts are more cautious and put significantly more emphasis on due diligence and post-valuation considerations
      - Future earnings and cash flows are key valuation considerations – what assumptions would a reasonable buyer use about the next 5-10 years in your market and niche?
      - It is still a Buyer's market – fewer willing and capable buyers (competitors are the most likely buyers in most markets)
      - Normalized EBIT (earnings before interest & taxes) projections are conservative and discounted for various factors
      - Lessons learned from wild-wild west acquisitions roll-up days of 2000-2005: construction is a people business. *If the key people quit post valuation or acquisition, it was primarily an asset purchase.*
      - Multiples are not automatically 6 to 10 times EBIT anymore
      - The post-valuation impact to operations is considered:
        1. Death or retirement of key personnel
        2. Loss of key personnel to competitors (or recent turnover)
        3. Reduced capital of a redemption resulting in less capacity
        4. Reduced surety or prequalification credit
        5. Delayed capital expenditures to "window dress" EBIT
        6. Market issues – new competitors, DOT funding, etc.

   b. Contingencies and earn-out clauses are now included in many acquisition and valuation calculations
      - Purchase price might be adjusted for actual revenues or earnings, quantities (tonnages or yards) or benchmarks – and contract "lookback"
      - Some payment could be contingent on key employee retention
      - Buy/sell agreements must consider post-death or post-redemption cash flow and earnings impact in valuation calculation

   c. Valuations vary significantly for type of contractor or niche
      - Without retention of key people, what is a GC (general contractor) worth? Specialty subcontractor? Asphalt paver? Bridge contractor?
      - Construction operations such as asphalt, quarries, ready mix, equipment intensive and specialty niches have a "barrier to entry" value. The value increases proportionately to the difficulty / cost of a start-up competitor.
      - Barriers include environmental permits, operating permits, licensing, prequalification, surety bonding, working capital requirements, etc.
      - Strength of customers and market growth potential is important

- Sureties remain concerned about significant acquisitions, redemptions and other ownership transactions

2. Understand the purpose of the valuation
   a. Acquisition or merger transaction
      - How long will it take to pay-off?
      - Will key people stay post-transaction?
      - Economies of a combined company? Combined fixed cost savings
      - Current competitor – contiguous operations or new area?
      - Less competition = higher profit margin?
      - Expected bump in post-acquisition market prices for combined units?
   b. Estate, gift and continuity planning
      - Did the lucky one die? All contractors should immediately calculate the buy/sell formula as if a key owner died – what is the financial impact?
      - Did the valuation formula damage the ability to continue after death?
      - A discount for minority non-controlling interest is appropriate
      - What is the post valuation (death, retirement, etc.) impact on bonding, licensing and prequalification capacities?
   c. Divorce or emergency need for owner liquidity
      - If working capital is reduced by 50%, what is impact to future earnings?
      - If property settlement is based on liquidation value of equipment, what is impact to earnings for alimony?
      - Many divorce valuations fail to consider the post-impact to earnings
      - Pre- and post-nuptial agreements excluding the company stock value are standard for most continuity plans. If not excluded, spouse signs buy/sell valuation agreement – stated value with terms.
   d. Stockholder / LLC Member redemptions
      - Stated value concept vs. appraisal methods
      - Death / disability / retirement / voluntary / involuntary
      - Haircuts for pre-retirement redemptions or disability are standard
   e. Phantom stock, performance shares or ESOP – annual valuations
      - Standard formula for phantom stock or performance shares
      - ESOP generally work poorly in construction because of unrealistic valuation assumptions
3. Construction industry valuation considerations:
   a. Risk – the higher the risk the higher the expected return on investment
      - 2nd highest failure rate industry
      - Labor intensive, weather, environmental, hazardous public activity
   b. Cyclical – roller coaster business cycles - heavily affected by recession
      - 60% of industry is subject to government funding
      - 2008 through 2010 was deepest post-war construction recession – 2020?
   c. Bonding, Licensing & Prequalification – based on tangible capital
      - Post valuation balance sheet must support going concern

- The valuation must consider the post-transaction impact on the future earnings of the entity. **If contractor cannot obtain surety bonds post transaction, how can you base the value on future earnings on prior year historical results?**
- Calculate effect on license and prequalification capacity rating

d. People – construction is a people business
- Will key employees stay post-transaction?
- How old are the key personnel?

e. Market area and competition
- Some areas have too many contractors
- Some niches are too cyclical

Valuation Process

4. Information needed to perform construction company valuations:

a. 5 to 10-years of financial statements and tax returns
- Including stockholder compensation & bonuses
- Details of extraordinary “non-recurring” income or expense
- Related party transactions

b. Current financial statements and related information
- Debt structure and terms
- Surety bonding program – minimum working capital requirements
- Uncompleted contract schedule (backlog) with POC calculations

c. Historical contract schedules (5-10 years)
- Sorted by type of work, customer, PM, location, etc.
- Historical fade/gain profit analysis

d. Copies of recent license renewal or prequalification forms

e. List of key personnel, date of hire, age, compensation
- Fringe benefit information / company vehicle

f. Equipment & vehicle depreciation schedules:
- Hour meter and/or odometer readings
- Maintenance records & capitalization policy

g. List of pending and resolved litigation for a 3-year period

h. Safety records and insurance policies for a 3-year period

i. Buy/sell and other owner agreements

j. Information regarding recent stock transactions

5. Adjusted Book Value Method (ABV)

a. Adjusted Book Value is typically the “floor”
- In today’s market; if no earnings, ABV may be highest value

b. Audited book value adjusted by:
- Fair market value of equipment (less tax liability and fix-up costs)
- Fair market value of non-business assets
- Reductions for intangible and other soft assets

- Off balance sheet tax liabilities
- Off balance sheet obligations (leases, contingencies, etc.)
- Unrecorded job fade or gain

c. Recommended basis for most owner buy/sell formulas

d. ABV could be supplemented by "rule of thumb" calculations for niches like asphalt, ready mix concrete, aggregates or similar operations to add value for intangible market area
  - Per yard or per ton multiples
  - Based on net expected cash flow per unit
  - Aggregate average annual tonnages sold x $50 (10 year x $5)
  - Asphalt average annual tonnages sold x $30 (6 year x $5)
  - Concrete average annual yards sold x $40 (5 year x $8 / yard)

6. Earnings Capitalization Method

a. Calculation of the expected cash flow available to purchaser for a period of time – capitalization years or "multiple"
  - Capitalization rate is simply the number of years it will take to "pay for itself" in cash return to the buyer
  - Assumes all after tax cash flow is 100% dedicated to pay back

b. What is risk that cash flow will continue/increase/decrease post valuation?
  - Are historical earnings a reliable basis for projections?
  - Can cash flow be realized by buyer for the capitalization period? 5-years? 10 years? What about a down-turn?
  - Are key personnel responsible for historical earnings still employed?

c. EBITDA is not appropriate for equipment intensive contractors

d. Normalization of Earnings Before Interest & Taxes (EBIT) calculation: 5 to 10-year historical profit adjusted for:
  - Excess owner compensation and benefits
  - Non-recurring revenue and expenditures – unusual contracts
  - Excessive rents paid to owners or related parties
  - Interest (passive) income and expense
  - Excess depreciation (it is not acceptable to use EBITDA without a reduction for cap-ex in construction)
    1. Review capitalization policy and useful life practices
    2. i.e. – plant depreciable life of 20-year v. 10-years
  - If EBITDA used, cap-ex adjustment should be at least 75% of average annual equipment purchases
  - Deduction for cumulative effect of job fade/gain (Most important adjustment in contract revenue normalization process)
  - Reduction of current year backlog to historical profit average

e. Current earnings capitalization multiples range from 3 to 10 times normalized EBIT (or EBITDA less cap-ex) depending on type/source of cash flow
  - General contractor – no niche 3x to 5x with golden handcuffs and earnouts
  - Subcontractors – depends on niche;

- Electrical, mechanical, HVAC, plumbing subs are highest - 6x to 8x range
- Drywall, painting, etc. are low – 3x to 4x range – ABV more common
- Grading, excavation, utility EBIT – 3x to 4x (ABV more common)
- Bridge and concrete construction – 4x to 5x (earn-out common)
- Ready mix concrete materials – 4x to 6x
- Asphalt materials and construction – 5x to 8x (7x most common)
- Aggregates – rock, sand, gravel - 7x to 10x (10x most common) – reserves must be 20+ years

f. Multiple considerations:
   - Barrier to entry contractors (asphalt, quarries, etc.)
   - Significant % of DOT and municipal work (higher multiple)
   - Significant % of private commercial / residential (lower multiple)
   - Negotiated vs. hard bid work
   - Bonded vs. non-bonded work
   - Workforce and retention of key personnel
   - Expected post-transaction market changes
   - Site lease, licensing or permit renewal issues
   - Supply issues – aggregate reserves, cement, liquid asphalt

g. Working capital at closing in excess of base amount is added to earnings capitalization calculation amount
   - Normal base is 5% to 10% of annual net revenue (7.5% is most common)
   - Only tangible working capital is included
   - Inventory is counted at closing with 90-day true-up
     1. RAP is valued at cost (processed v. un-processed
     2. Obsolete, non-turning and excess RAP is de-valued
   - Excess working capital is usually put in escrow pending A/R collections

h. Add back value of non-business assets (land, investments)

i. Earnings capitalization method assumes "debt free" calculation
   - Long term debt is deducted from net value calculation (including leases)
   - Short term debt is deducted from working capital adjustment

j. Lookback true-up on work in progress backlog is standard
   - One year is common – but longer is significant long-term job
   - Purchase price is adjusted up or down depending on final profit
   - Usually some amount held in escrow (equal to POC backlog gross profit)

k. Use of "Earn Out" provision is popular in acquisitions
   - Eliminates some risk for lack of work
   - Tied to key employee retention
   - Often based on per ton/yard benchmarks
   - Look-back adjustment for profit fade

l. For estate and gift valuations, earn-outs are not practical.
   - Use lower multiple instead
   - Build more contingencies in normalized earnings projections

7. ***Do Not:***
   a. Use EBITDA – depreciation is real in construction
      - EBITDA less annual cap-ex (actual or prior average)
   b. Combine adjusted book value method and earnings cap method using a weighted average – not applicable to construction industry
      - If you sell equipment, there will be no more earnings
   c. Let insurance salesmen scare you, the IRS is not unreasonable about valuations
      - The IRS understands the bonding and licensing issue
      - Discounts are still acceptable
   d. Use "appraisal" or "fair market value" in buy/sell agreements.
      - Use a stated value and revise the amount annually – signed by all owners
   e. Use publicly traded company stock multiples – they are irrelevant

8. ***Do:***
   a. Use discounts for certain valuations (redemption, buy/sell, divorce, gifts):
      - Minority interest (or lack of voting control)
      - Lack of marketability – stock sale restrictions
      - Loss of key personnel (if death or departure of personnel is reason for valuation)
      - Lack of consistent profitability
      - Discounts range from 25% to 45% depending on circumstances (30% is safe haven for estate and gift tax)
   b. Review buy/sell agreements and formulas
      - Calculate current valuation amounts and related cash flow impact
      - Disclosure required under FAS 150 if significant
      - Best practice – use Stated Value
        1. Updated and signed annually by all owners
        2. Usually based on ABV with discounts
        3. Consider life insurance and payment term
        4. Lookback, tag-a-long and skip payment provisions are standard
   c. Consider <u>tag-a-long</u> type provision in a valuation
      - If company is re-sold subsequent to valuation transaction (3 to 5 years)
      - Allows participation in subsequent windfall – "fairness provision"
   d. Consider a post-valuation earn-out adjustment in acquisition valuations:
      - Actual revenue/tonnages/yards/gross profit vs. projected
      - Profit fade or gain lookback – escrow % of backlog revenue of POC profit
      - Unrecorded liabilities
      - Post-completion job settlements and call-back expenses (claims)

e. Consider golden handcuffs for key employees post transaction
    - Employment 3-years after sale will share "pool" of funds set aside in purchase price
    - Deferred bonus or phantom stock
    - Newco ownership participation

Contractor Acquisition
Confidential Information Checklist

Provided after execution of confidentiality and non-disclosure agreement.
Note: A signed non-binding letter of intent may be required by seller prior to providing certain information on list below.

A. Purchase Price

1. Estimated asking price or range, net of debt assumption
2. Calculation used to determine asking price:
    - Earnings normalization schedule with add-backs and deducts
    - EBIT calculation with list of non-recurring income and expenses
    - Appraisals of equipment and fixed assets
3. List of assets to be included in purchase (or excluded assets)
4. List of liabilities to be assumed in purchase
5. List of owners/key managers to remain after purchase
6. Is a broker involved in the sale of the company? If so, commission %?

B. Financial

1. 5-years of audited / reviewed financial statements including completed and uncompleted contract schedules and all disclosures
2. Most recent interim balance sheet and income statement including completed and uncompleted contract schedules
3. Current list of backlog and estimated backlog gross profit
4. Contract gross profit fade/gain lookback schedules for past 5-year period
5. Accounts receivable aging reports for the prior year-end and year-to-date
6. Notes payable and financing agreements
7. Auditors' management letters / comments for last 3-years
8. Owners' and key managers' salaries and bonuses for the last 5-years

C. Taxes

1. Federal, state and local income tax returns for past 3-years
2. Notices from all federal, state and local tax authorities for last 3-years, including IRS audit letters

3. Tax depreciation schedules for most recent year-end
4. Verification of current status of payroll tax, sales tax, excise tax, fuel tax and other business taxes
5. Authorization to discuss tax compliance issues with CFO and independent CPA for the Company

D. Equipment and Other Fixed Assets

1. Copies of fixed asset depreciation schedules for most recent year-end
2. Copy of equipment list including make, model, serial number, original purchase price, hour meter or odometer reading, and insured value
3. List of fixed assets excluded from purchase / acquisition
4. Copy of appraisals, if any
5. Average annual capital expenditures for prior 5-years – separate replacement Cap-Ex and capacity expansion Cap-Ex
6. Detailed schedules of repair and maintenance costs for prior 5-years
7. Capitalized repair and maintenance costs in prior 5-years by equipment number
8. Describe equipment cost allocation methods and rental rate system
9. List of internal equipment rental rates - include average equipment utilization percentage schedules by equipment piece for most recent period
10. List of leased equipment with monthly rental and remaining minimum payments

E. Prepare a schedule sorting revenue and gross profit by largest contract owners / customers for the prior 5-years:

1. DOT
2. Federal Highway Administration
3. Municipal and County
4. Private
5. Dept. of Defense
6. Other

F. Prepare a schedules sorting revenue and gross profit by type of work for the prior 5-years:

1. Bridge
2. Asphalt paving
3. Concrete paving and curbs
4. Grading, drainage and pipe
5. Utility work
6. Site work

G. Materials Manufacturing

1. Number and location of asphalt or concrete ready-mix plants
2. Description of each plant and related market area
3. Annual tons / yards produced by each plant for prior 5-years
4. Revenue and gross profit by plant for the prior 5-years
5. Plant site information, acreage, lease terms, owned?
6. Permit status; transfer issues; pending violations or issues.

H. Operations/Employees

1. Compensation data for management and salaried employees for last 3-years:
    - Name, age, hire date, title and major responsibilities
    - Base salary
    - Bonuses paid in prior year
    - Benefits
    - Other deferred compensation, phantom stock or similar arrangements
    - Vacation and holiday
2. Employment contracts and non-compete agreements
3. Explanation of executive bonuses, benefits and other compensation programs
4. Nature of any consulting agreements with outside parties
5. Management resumes
6. Health insurance plan and related employee co-payment requirements
7. Union agreements and most recent contract terms

I. Industry/Competition

1. Main competitors including firm name, location and size
2. Relevant data from any trade associations/periodicals that highlight market size/growth, competitive dynamics and outlook for the geographic area
3. Non-compete agreements in effect with other companies

J. Information Technology

1. Accounting software system
2. Estimating and bidding software system
3. Contract management software system
4. Field reporting systems, GPS tracking, etc. for labor and equipment

K. Legal & Other

1. Copy of charter, articles of incorporation (or LLC registration), operating agreements or by-laws, minutes for the prior 3-years

2. Schedule of ownership - including name, shares, percentage
3. Buy/sell or stock redemption agreement
4. Summary of all pending litigation both as plaintiff and defendant:
    - Name and address of legal counsel for each matter
    - Managements’ estimate of financial impact
5. Non-business assets included (or excluded) in purchase
6. Copies of insurance policies - include information regarding self-insurance, captive participation, deductibles, mod rates, etc.

Construction Contractor		**Chapter 5 - Exhibit A**			
Valuation - Earnings Capitalization Method					
Adjusted EBIT Computation	Year Ended 12/31/2013	Year Ended 12/31/2014	Year Ended 12/31/2015	Year Ended 12/31/2016	Year Ended 12/31/2017
Net Income (Loss)	**$ 100,000**	**$ 1,700,000**	**$ (200,000)**	**$ 1,000,000**	**$ 2,000,000**
Additions to net income					
Excess compensation paid to owners	10,000	200,000	50,000	500,000	500,000
Compensation paid to family members	-	-	-	-	-
Excess depreciation adjustment	-	-	20,000	50,000	50,000
Related party rent in excess of FMV	50,000	50,000	50,000	50,000	50,000
Loss from non-business investments	-	10,000	-	-	-
Interest expense	20,000	30,000	20,000	20,000	20,000
Airplane expenses	-	20,000	20,000	20,000	20,000
Extraordinary contract loss (non-recurring)	-	-	-	420,000	-
Other - nonrecurring expenditures	-	-	55,000	-	-
Net additions to income	**80,000**	**310,000**	**215,000**	**1,060,000**	**640,000**
Deductions from net income					
Nonrecurring income	-	-	100,000	-	-
Investment and interest income		-	-	10,000	10,000
Gain on sale of assets - nonrecurring	-	75,000	-	40,000	-
Unrecorded losses reserves - 2017 only	-	-	-	-	60,000
Percentage of completion adjustment	-	-	-	-	(300,000)
Net deductions from income	**-**	**75,000**	**100,000**	**50,000**	**(230,000)**
Contingency deductions	-	-	-	-	(200,000)
Estimated Normalized EBIT	**$ 180,000**	**$ 1,935,000**	**$ (85,000)**	**$ 2,010,000**	**$ 2,670,000**
Average Annual Net Income	**$ 1,342,000**				
Weighted factor	1	2	3	4	5
Weighted amount	180,000	3,870,000	(255,000)	8,040,000	13,350,000
Weighted Average	**$ 1,679,000**				
Excess Tangible working capital computation:					
Reported working capital	$ 6,200,000				
Deduct:					
Excess inventory - scrap / obsolete	(250,000)				
Related party A/R	(50,000)				
Under / over billing POC adjustment	(300,000)	(Fade analysis)			
Unrecorded liabilities	(50,000)				
Off balance sheet tax liabilities	-	(stock redemption)			
Tangible working capital	5,550,000		Annual self-performed revenue:		
Less benchmark minimum	(3,750,000)	7.50%		$ 50,000,000	
Excess (deficit)	$ 1,800,000				
Earnings Capitalization Valuation:	5x EBIT	7x EBIT	10x EBIT		
EBIT (5-year weighted average)	$ 1,679,000	$ 1,679,000	$ 1,679,000		
Cap rate - years	5	7	10		
Earnings capitalization	8,395,000	11,753,000	16,790,000		
Add excess working capital (deficit)	1,800,000	1,800,000	1,800,000		
Excess FMV of non-business assets	-	-	-	(Land, buildings, etc.)	
Less cap-ex requirements - post closing	(800,000)	(800,000)	(800,000)		
Less long term bank debt at closing	(1,000,000)	(1,000,000)	(1,000,000)		
Valuation	$ 8,395,000	$ 11,753,000	$ 16,790,000		

CONTINUITY PLANNING FOR CONSTRUCTION CONTRACTORS: OLDCO / NEWCO STRATEGY

By: Robert A. Davidson, CPA **Exhibit B**

Closely held contractors, regardless of size or type, generally share a common problem: designing and implementing a continuity and ownership transition plan that will provide reasonable financial benefits to retiring owners but provide for the continuity and transition of operations to the next generation of owners. Most contractors recognize the significant contribution to value made by their key management over the years and prefer a plan that allows them to be owners or participate in future profits of the company.

Although a company liquidation is an option, it generally results in the lowest amount of financial benefit to the existing owners. Due to the costs of completing contracts in progress over the liquidation period, owners rarely net the full book value of the company (adjusted for appreciated equipment or property). Furthermore, liquidation is the least favorable option for key next generation personnel. They are on their own to find a new job.

A third-party sale is an option for certain types of contractors. Companies with a "barrier to entry" niche such as asphalt and aggregate manufacturers/contractors will benefit from a large earnings-cap multiple valuation. Other contractors that have no tangible assets and rely more on people and relationships will not benefit from a high valuation – making a 3rd party sale less attractive. Finding the right buyer willing to pay a reasonable price without a contingent earn-out provision is difficult. Most 3rd party transactions generally require continuing involvement by the retiring owners during the earn-out period and the new owners might not be a good fit for the key employee group.

An employee stock ownership plan (ESOP) is a fit for certain contractors, but the success rate in the construction industry is rare. The surety industry benchmarks and the inflexibility of the legal requirements make an ESOP a bad option for most contractors. Spreading ownership between all employees with the resulting "too many cooks in the kitchen" is not a good plan for most contractors.

The most popular continuity and ownership transition plan for contractors is the Oldco/Newco concept. This plan allows for the transfer of ownership to key employees only and the maximization of financial benefits to the retiring owners.

Oldco/Newco

If designed and implemented properly, a Newco plan will provide for the retirement of company owners and also provide the necessary structure and incentives that will facilitate the transfer of ownership and continuity of the operations to the new management team.

Using this structure provides a means to transfer the operations of the business to those individuals desiring an equity ownership. This can be anyone, but normally would be limited to family members and key employees that the owners know and trust. Which individuals to include is a very important decision. The future of the company and the ability to retire will rest with those selected.

To help illustrate how this structure works, consider the following illustration:

- Oldco is a S Corporation – in business over 20 years
- There are two 50/50 owners; 3 Newco owners
- Current equity of Oldco = $2,000,000
- Oldco owners would like to retire in 3 to 5 years

Formation of the Entity
The first step is to form the new entity, Newco. In order to allow for the necessary transactions between companies, it is generally recommended that Newco organize as a Limited Liability Company (LLC). As an LLC, money transferred from Oldco to Newco, either as capital or loans, can be done without the concerns of dividend treatment that would be present if Newco were formed as a corporation.

The Newco generally selects a name that is substantially the same as Oldco. For example, if Oldco is "Acme Construction, Inc.", Newco is named "Acme Construction, LLC". This allows for the smooth transition of goodwill, market recognition and experience to the new entity over time.

Capitalization
The next step is to capitalize Newco. The amount of capital needed will vary depending on the licensing and bonding requirements of the business. Consideration should be given to obtaining sufficient capital to qualify for an unlimited contractor's license and satisfy any prequalification bidding capacity. Many states require at least $300,000, which will be used in this illustration.

The two retiring owners of Oldco will make a capital contribution of $15,000 each for 5% of the ownership (10% combined) and will be named as managing members in the operating agreement. The LLC operating agreement should include all aspects of the relationship between Oldco and Newco including voting, vesting, non-competition, bond indemnities, intercompany transactions, common paymaster, final transition goals, etc. This agreement will include stipulated amounts due to Oldco for items such as management fees, equipment rent and surety indemnification fees to compensate Oldco and its owners for their participation in Newco.

The next generation of owners will contribute the remaining $270,000 of initial capital. Assuming 3 equal owners of Newco, each will contribute $90,000. It is common for the Newco owners to require a loan from Oldco or a Bank to fund this initial capital contribution. The Oldco entity may be required to guarantee the loan to Newco owners for the initial capital.

Licensing and Surety Bonding
After Newco has been formed and capitalized, it will be required to obtain contractors' licenses and tax registrations in each state in which it will be doing business. For surety bonding purposes, depending on the amount of capital invested, Newco will need to be cross-indemnified with Oldco. The surety bond indemnification can be reduced and eventually eliminated as Newco establishes its own job history and increases its own equity and working capital. It is important for Oldco and Newco owners to meet with the Surety Company during the formation and organization of Newco.

Once all licensing and bonding is in place, Newco will begin bidding on contracts. The owners of Oldco and Newco should prepare a business plan with projections and pro-forma financial statements to establish a timetable for the transition of operations. For example, the owners may establish a goal for contract revenue to be about 50/50 between Oldco and Newco by the end of year 3. By the end of year 5, the goal might be to have $1 million in equity in Newco and all contracts bid by Newco after year 5.

Operations
In the beginning, Newco will rent any equipment it needs from Oldco. If any new equipment is required, the purchase will be made by Newco. During the buyout period, Newco will eventually purchase any remaining equipment owned by Oldco. This will be at a discounted fair market value or determined in

advance. By renting at first, Newco conserves cash flow and does not have to obligate itself to any long-term debt or leases.

In order to compensate the owner's of Oldco for their assistance in the conversion, Newco will pay management fees and indemnification fees to Oldco. A systematic and reasonable method for calculating these fees should be established in the operating agreement. For example, the surety indemnification fees can be an agreed upon percentage of total contracts awarded during each year. Management fees can be established to cover Oldco overhead and salaries during the transition. The management fees can be used to level the equity build-up to prevent unfair contract cherry picking or other anomalies during the transition period.

Once Newco has completed the transition in 5 years, it can buy out the interests that the Oldco owners have in Newco. This is one of the items that can be prearranged in the operating agreement. The operating agreement can establish both the timing of the buyout and the valuation method. Since the Oldco owners initially only contributed capital for a ten percent (10%) interest, this buyout should not create a burden on Newco.

Since Oldco has transferred its operations to Newco, accounts receivable, work in process, inventories and equipment have been converted to cash. Assuming Newco is now adequately capitalized to support bonding and cash flow needs, Oldco can be liquidated and cash distributed to Oldco owners.

As with any new business, there are other items that should be considered when forming Newco. One of these is the possibility of obtaining life insurance on the Oldco owners to allow for the buyout of Oldco in the event of the death of one or more of the owners. Another item is a buy-sell agreement between the Newco partners. This will be much easier to accomplish if done up front rather than waiting until after the new company becomes profitable. This, like the buyout agreement for the Oldco interests, should set the method for valuing the partnership.

Other Considerations

Although retirement may be the driving force behind setting up a Newco continuity plan, the benefits of key employee incentive and retention are equally as important. Newco plans are designed as "golden handcuffs" to provide ownership incentives to young experienced employees. Most Newco operating agreements include a vesting schedule for Newco owners to prevent premature departure (and a drain on capital) during the 5-year transition period. It is not uncommon to include a provision that departing Newco owners will be paid their initial capital only if separation occurs during the first 5 years. The operating agreement will address the valuation of ownership redemption for involuntary, voluntary, retirement, death and disability events.   The agreement will also address voting, profit sharing, compensation and other management issues after the departure of the Oldco owners and the transfer of their voting control to the Newco owners.

Summary

Like any continuity plan, the devil is in the details and one-size does not fit all. Newco is not for every situation but should be considered by contractors looking for an alternative to ESOP, liquidation or 3rd party sale. To work properly, Newco plans require a commitment from the Oldco owners to stick around for 3-5 years to provide cash flow, bonding and managerial support. It also requires a commitment from Newco owners to exercise "ownership thinking" and be willing to self-capitalize the new entity for 3-5 years to retire the Oldco owners and establish a new entity with the capital required to support bonding, licensing and operations. It is important to design an operating agreement and establish financial goals and objectives for the Newco transition.

CHAPTER 6 - Construction Taxation – Fundamentals & Strategies

A. Tax Law Revisions affecting Contractors due to the Tax Cuts and Jobs Act Passed in December 2017

1. Top individual rate tax rate drops to 37%, down from 39.6% beginning in 2018.
2. Passthrough income receives a 20% deduction from qualified business income limited to 50% of wages. Very similar to the domestic production activities deduction that has now been eliminated. The deduction may be limited or disallowed for personal service income and rental real estate based on taxable income.
3. With the drop in the top tax bracket and the new 20% deduction, the new effective rate for passthrough construction businesses is 29.6% (at maximum tax brackets) down from 36%.
4. Threshold for Completed Contract Method increases to $25 million in gross receipts from the current $10 million level. This is based on the prior 3-year average gross receipts
5. Equipment purchases may now be expensed fully in the first year. This applies to both new and used equipment. This provision begins to phase out in 2022.
6. Section 1031 exchanges are now limited to real property held for investment. This means that construction equipment exchanges are no longer eligible for 1031 treatment.
7. Corporate AMT has been repealed for C Corporations. The individual rate has remained, but the exemption has increased to $70,300 single and $109,400 for joint tax returns. The phase out has increased to $500,000 for single and $1,000,000 for joint tax returns. AMT still applies for individuals and passthrough entities.
8. Interest expense deductions are now limited. The deduction of net interest expense is limited to 30% of the business's Adjusted Taxable Income (ATI is similar to EBITDA). Disallowed interest deductions will carry forward.
9. Net Operating Losses (NOLs) may no longer be carried back. This includes losses in 2018 that will not be able to be carried back to 2017 or earlier. NOLs now carry forward indefinitely but are limited to 80% of taxable income.
10. The top corporate tax rate has been lowered from 35% to 21%.

B. Tax Methods Available to Contractors

1. Cash method
    a) Revenue recognized when cash is received and expenses deducted when paid
    b) Eligible taxpayers include:
        i. C-Corporations with average gross receipts less than $25,000,000 under the Tax Cuts and Jobs Act increased from the previous $5,000,000 in gross receipts
        ii. Qualifying taxpayers with average annual gross receipts of $25,000,000 or less under the new Tax Cuts and Jobs Act increased from the previous $10,000,000 in gross receipts
        iii. This is currently a non-automatic change but it is expected that the government will update Rev. Proc. 2017-30 to include it as an automatic method change to cash basis allowed if elected by due date of return
    c) IRS alert to possible abuses. Impairs financial ratios

2. Accrual method
    a) Revenue recognized the earlier of when earned or received
    b) Expenses are deducted when the "all-events" test has occurred but not before economic performance has occurred
    c) Rev. Proc 2004-34 (deferral of advance payments)
    d) Worst method for contractors (overbilled = taxable!)
    e) Accrual basis contractor can exclude retainages receivable (Rev. Rule 69-314)
        i. Included in income only after final acceptance of work performed
        ii. Election to use method is required
        iii. Method change "automatic" per Rev. Proc. 2008-52
            - Section 15.10
            - Automatic change #130
            - Form 3115 filed after August 18, 2008
        iv. Must also exclude any retainages payable from expenses *(Shepherd Construction Company v. Commissioner)*
        v. Available for contracts exempt from POC including non long-term contracts
    f) Prepaid insurance
        i. Regs. Sec. 263(a)-4(f)
            - Allows a deduction for prepaid expenses (specifically including prepaid insurance) that does not cover a period extending more than 12 months beyond the end of the taxable year in which the expense is incurred
            - The expense must meet all other requirements for deduction
                - All events that establish a liability exists have taken place
                - The amount of the liability can be determined with reasonable accuracy
                - Economic performance has occurred with respect to the liability
        ii. Consider a change in accounting method
            - Allowed as an automatic change under Rev. Proc. 2005-9
3. Completed Contract Method
    a) Revenue and costs incurred on a contract are not recognized until the contract is completed <u>and</u> accepted *(Ball, Ball & Brosamer v. Commissioner*, T.C. Memo 1990-454 (Space Shuttle Runway))
    b) Regulations require completion when 95% complete <u>and</u> owner occupies (1.460-1(c)(3))
    c) Generally, results in the greatest deferral of income
    d) Use of CCM is limited to certain contracts performed by "small contractors". Prior to 2018, the small contractor limitation was $10,000,000 or less. The Tax Cuts and Jobs Act (passed in 2017) increased the limitation to average gross receipts of $25,000,000 or less.
    e) Available for certain contracts which are exempt from IRC 460

4. Percentage of Completion Method (POC)
    a) Recognizes revenue on the percentage of contract completion, determined by the total cost to date over total estimated cost
    b) Method relies on the use of estimates
    c) Applies to all contracts not exempt from IRC 460. Generally, POC is required to be used by large contractors with average annual revenue over $25,000,000
    d) Contracts that are potentially exempt from POC under IRC 460:
        i. Home construction contracts
        ii. Residential contracts (30% only)
        iii. Contracts performed by small contractors
        iv. Non long-term contracts
        v. 10% election
    e) Other issues affecting POC revenue recognition
        i. All-events test required by 461(h) economic performance rules
        ii. *Tutor-Saliba Corporation v. Commissioner* (115 T.C., No. 1) (claims taxable when filed)
        iii. G&A allocation to long-term contracts (Reg. 1.460-5)
        iv. Exclusion of retainages payable from costs incurred to date (ISP MSSP IRPO 180, 118)
            - Exclusion not allowed if "Pay when Paid" clause applies (varies from state to state).
        v. Claim revenue recognized to extent of cost incurred (Coordinated Issues Paper 7/20/06)
5. Taxpayer allowed to use more than one method of accounting
    a) Rev. Rule 92-28
6. Limitations are based on contracts, not contractors

C. Internal Revenue Code Section 460

1. 460(a) requires use of percentage of completion (POC) for long-term contracts
2. 460(b)(1)(B) requires computation of interest under the lookback method
3. 460(c) requires allocation of costs to contracts
4. 460(e) exemptions from required use of POC

D. Internal Revenue Regulations

1. 1.460-1 long-term contracts
2. 1.460-3 exempt construction contracts
3. 1.460-4 methods of accounting for long-term contracts
    a) Cut-off method used for method changes after 1/1/01 (1.460-4(g))
    b) Does not allow (require) Section 481 adjustment (4 year spread) for any changes in method
    c) Mid-contract changes in taxpayer
4. 1.460-5 cost allocation rules
5. 1.460-6 lookback method

E. Alternative Minimum Tax

1. Contractor preference items
   a) Long-term contract preference
   b) Depreciation
   c) Percentage depletion
   d) Basis difference on sale of fixed assets
2. Individual rate is 26-28%. The corporate AMT has been eliminated beginning in 2018
3. Most states do not charge a minimum tax
4. Prepare Form 6251 for individuals, even if not applicable
5. Impacts pass-through owners (S-Corporations & LLCs)

F. Look-back method

1. Required to pay or receive interest based on completion of POC jobs
   (Regular tax or AMT)
2. Recalculate contract gross profit
3. Recalculate tax liability
4. Compute interest due to/from government
   (Interest Rate = IRS Overpayment Rate)
5. Prepare Form 8697
6. File Corporate Form 8697 in Cincinnati; flow-through owner Form 8697 in Philadelphia (file returns using certified return receipt - earns interest)
7. Per IRS: 71% not filing - 84% filed have errors
8. Impacts pass-through owners (S-Corporations & LLCs)

G. Passthrough Business Deduction (Replaces Code Section 199)

1. Passthrough income receives a 20% deduction from qualified business income limited to 50% of wages.
   a) Pass-through entities apply deduction at owner level
   b) Some states will not allow the deduction
   c) Partners' earnings or guaranteed payments do not qualify as wages
   d) Deduction is limited for personal service income and rental income. The deduction begins to phase out at taxable income above $157,500 (single) and $315,000 (joint) and is fully phased out at $207,500 and $415,000. This provision sunsets after 2025. Rental properties with net income after amortization and depreciation will receive the lesser of a 20 percent deduction on net income or a 2.5 percent deduction on the property's unadjusted basis.

   e) Be aware of tax impact of paying large salaries and/or bonuses to owners of passthrough entities. Expect additional IRS focus on salary levels for owners.

H. Accumulated Earnings/Excess Compensation

1. Bonding requires heavy equity and working capital
2. Cyclical nature of industry
3. Use of S-Corporations & LLCs
4. *ACME Construction Co., Inc.*, T.C. Memo 1995-6
   (Past service allowed. Compensation = net income)

5. *John L. Ginger, Inc. v. Commissioner*, T.C. Memo 1997-251
   (Compensation + $1 million allowed)
6. *Wagner Construction v. Commissioner,* T.C. Memo 2001-160
   (Base salary = $40,000 bonus = $1 million)
7. *Miller & Sons Drywall, Inc. v. Commissioner*, T.C. Memo 2005-114
   a) Allowed salaries = 35% gross receipts and 105% of net income
   b) Return on investment = 15.8% average during years in question

I. Depreciation Methods – December 2017 changes

1. Equipment purchases may now be expensed fully in the first year for both new and used equipment. This law applies retroactively to September 27, 2017. This provision phases down by 20% per year beginning in 2023.
2. Building component depreciation will qualify for 1-year write off if personal property class
3. Section 179 permanent **-** $1,000,000 new or used expensed if purchases less than $2 million

J. Credits Available to Contractors (or Their Customers)

1. Research and development credits (rare)
2. Energy credits (pass through on government buildings)
3. Historical structure tax credit – 20%
4. Non-historical tax credit – 10%
5. Work opportunity credits
6. Fuel tax credit (off-road use of undyed fuel)

Most Commonly Missed Construction Tax Strategies

A. Exempt Contracts are Not Subject to POC

1. Home construction contracts are exempt from Code Section 460
   a) Home construction contracts defined in Regs. 1.460-3(2)
   b) Includes common improvements contractually obligated or required
2. Residential construction contracts are eligible to use percentage of completion capitalized cost method (POCCCM) (Sec. 460(e)(5))
   a) If required to use POC, 30% of contract is exempt
   b) Definition same as home construction, except for "more than four dwelling units"
   c) Exempt portion uses "normal" method of accounting
3. Code Section 460 only applies to long-term construction contracts (460(a))
   a) Does <u>not</u> apply to non-long-term contracts
   b) Does <u>not</u> apply to construction management, etc.
   c) Use "normal" method of accounting for non-long-term jobs and non-construction contract activity (cash/accrual excluding retainage)
   d) Revenue Ruling 92-28 allows (requires) use of different methods for exempt and non-exempt contracts within the same trade or business
4. Revenue is not reported for contracts less than 10% complete (460(b)(5))
5. Contractors with average annual revenues of less than $25 million are exempt. Contracts subject to POC are determined annually on a cut-off basis. <u>No method change required or recommended</u>.

B. Contract Method Changes Allowed if Filed by the End of the Tax Year

1. Changes in methods for reporting contract revenue are allowed on a cut-off basis (1.460-4(6))
2. Taxpayer-initiated changes are not permitted or required to report a Section 481(a) adjustment
3. Initial home construction/residential construction contracts elect method on first return
4. Cash and accrual method changes are automatic and allowed up to extended due date of the return
5. Negative 481(a) adjustments for cash and accrual methods are allowed in first year
6. Changes to accrual excluding retainage are automatic
7. Current cost = $8,600

C. Cost Allocation for Contracts Subject to Percentage of Completion (POC) Requires Change in Estimated Costs

1. Direct and indirect costs must be allocated in the same manner as Regs. 1.263A-1(e) through (h) (Reg. 1.460-5(b))
2. All costs that directly benefit or are incurred by reason of the performance of the long-term contract must be allocated.
3. Estimated cost must be adjusted to account for additional cost allocation <u>and</u> projected cost allocation
4. Allocation of bonuses to profitable jobs
5. Allocation impacts lookback returns

D. Alternative Minimum Tax Preference Item Only Applies to Certain Long-Term Contracts

1. Non-long-term contracts are exempt
2. Home construction contracts are exempt
   (30% residential preference is not exempt)
3. 10% election deferral is exempt
4. The difference between POC and tax method of accounting for contracts is a preference
5. No longer applies to C-Corporations
6. Equipment electing 100% bonus is exempt
7. Equipment electing Section 179 is exempt
8. Calculated at owner level for flow-through entities

E. Lookback Tax Returns (Form 8697) Are Not Prepared

1. Long-term contracts, subject to POC, completed during the year are subject to lookback calculation (includes alternative minimum tax)
2. IRS reports 71% of required tax payers <u>DO</u> <u>NOT</u> file
3. Interest refunds on job fades and warranty costs
4. Interest due on gain jobs
5. Home construction contracts are exempt
6. Final contract cost includes costs allocated as required by Code 460(c) and regulations
7. Step-in-the-shoes treatment for mid-contract changes
8. Interest due on claims discounted using federal mid-term rates
9. Calculated at owner level for flow-through entities
10. Prior to year-end -- close faded jobs & carryover gain jobs

F. Failure to Maximize Tax Depreciation Deductions

1. Use of incorrect useful lives for construction equipment
   a) 5 years for construction equipment
   b) 7 years for plants (asphalt, crushers, concrete)
2. Capitalization of repairs and maintenance
   a) *Ingram Industries v. Commissioner*, T.C. Memo 2000-323
   b) *Revenue Ruling 2001-4* (Aircraft Overhaul)
   c) Tangible personal property regulations effective 1/1/14
3. Code Section 179 expensing for new or used equipment
   a) $1,000,000 on purchases up to $2,000,000 – effective 1/1/18
4. Maximize 100% bonus depreciation on new and used equipment purchased on or after September 27, 2017
   a) Provision sunsets December 31, 2022
   b) Applies after Section 179 is taken.
   c) Applies to expenses to rebuild or recondition used equipment
   d) Several states not allowing bonus depreciation
   e) Applies to certain leasehold improvements
5. SUVs and construction vehicles are exempt from luxury auto limitations
   (CCH 15,108.022)
6. Failure to utilize like-kind exchange deferrals

7. Maximize cost segregation for real property and plant construction
8. Write-off obsolete or abandoned equipment (property tax savings)

G. Failure to Utilize Credits or Deductions

1. Energy
2. Historical tax credits
3. Employment
4. Fuel

H. Failure to Calculate and Maximize the Depletion Deduction on Quarry, Sand & Gravel Operations

1. Percentage depletion equal to 5% of gross sales
2. Limited to 50% of net income of property
3. Available to both lessee and lessor of property

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