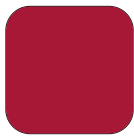

QUESTIONS EVERY CONTRACTOR SHOULD ASK THEIR CPA PRIOR TO YEAR-END

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ROBERT MERCADO AND CHRISTOPHER SISK

Prior to year-end, it is important for construction company owners and management to plan ahead to place the company in the best possible financial and tax position. This is the time of year companies get to report their internal information to outside users (i.e., banks, sureties/bonding agents, state licensing/contracting boards, etc.), and it is imperative they put their best foot forward in presenting their financial statements. This is also the time for business owners to ensure they have a proper financial plan for income tax purposes to avoid unanticipated tax liabilities. Important questions contractors should be asking their CPAs before year-end are as follows.

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Business financial planning

What should my target working capital be? How does this affect my bonding and licensing? Working capital, which is the difference between current assets and current liabilities, is one of the most important ratios for a contractor. Contractors should focus on what their working capital, as well as tangible working capital, will be at year-end. Contractors should take appropriate action immediately to manage and control this financial ratio as best as possible. There are several adjustments that could have material effects on working capital that should be anticipated and planned for (e.g., income tax accruals or adjustments, employee bonus accruals, current portion of debt payments and related terms of new financing agreements for year-end equipment purchases, contract percentage-of-completion adjustments, etc.).

Working capital is a key driver of a contractor's bonding program and determines the level of license issued by state or local

governments. Understanding the inputs and accounts that affect the working capital ratio is critical and must be managed with laser focus at year-end. Working capital should be a minimum of 10 percent of a company's top line revenue. If it is below that percentage, it can directly affect the amount of work a contractor can pursue in the following year.

Is the company on track to meet financial covenants? Reviewing covenant calculations subsequent to year-end should not be the first time a contractor has considered their compliance with requirements from financial institutions. Covenant calculations should be reviewed on a regular basis. While failing a covenant may not be the worst-case scenario, it will create additional work for the contractor. This includes requiring additional disclosures in financial statements (it can also delay the release of the financial statements), obtaining a waiver from the bank (which can be costly), and potentially modifying the debt agreement. If it is anticipated that a covenant may not be met, contractors should start the discussion process with the bank as soon as possible. It is recommended to communicate early with the bank rather than to try obtaining a waiver at the time the financial statements need to be issued; waivers can sometimes take a long time to get approved and issued by the bank.

How does the company's projected financial ratios compare to best-of-class contractors? How can they be improved? There are various sources that can be utilized to gather industry benchmarks and in-depth industry analysis of contractors. A CPA should be able to assist contractors in understanding how their company is performing and comparing them to others in their niche specialty. This helps the contractor understand what strategies can by employed to become best-of-class financially. General ratios are not the always the best measure. Contractors should analyze construction industry–specific ratios such as backlog and backlog gross profit, job borrow and permanent job borrow, and gain/fade analysis on projects.

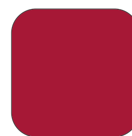
Should a contractor consider a long-term line of credit to increase working capital and cash flow? This can have an immediate impact on increasing working capital and is a strategy many contractors employ. If a contractor enters into a line of credit that has an expiration date more than a year and a day from the contractor's year-end, and it is expected to be renewed by the financial institution, any borrowings outstanding on the line of credit can be shown as long-term liabilities. This allows contractors to increase their cash balance and working capital at year-end without the related borrowing effect hitting their working capital.

Are there any balance sheet "clean up" items or adjustments that should be made prior to year-end? How do these changes affect our taxable income? Most contractors have items on their balance sheet that may have accumulated during the year or are posted incorrectly. Prior to year-end, take time to clean things up and ensure transactions are correctly posted and classified. What items are named and where they are classified on the balance sheet can have financial impacts and can determine how items are treated for tax purposes.

Business income tax

What deferred tax items will turn around in the current year from the prior year? There are many tax deferral opportunities a contractor can take advantage of, but contractors should take into account that deferrals from the past can turn around and impact the contractor when they least expect it. Section 460 of the Internal Revenue Service Tax Code allows contractors to defer certain taxable income based on the methods employed for tax-reporting purposes on long-term construction projects. When items are deferred into the future, it is important to be aware of those deferrals and plan for when those items will turn around. It is also important to understand the type of projects that will be in progress at the contractor's year-end that can provide additional opportunities to defer taxes into the future.

What is the estimated amount of taxable income the company will have at year-end? Determining this amount is the starting point for contractors and is extremely vital. Knowing this amount determines the decisions a contractor makes in the last few months of the year about matters including



WHAT ITEMS ARE NAMED AND WHERE THEY ARE CLASSIFIED ON THE BALANCE SHEET CAN HAVE FINANCIAL IMPACTS AND CAN DETERMINE HOW ITEMS ARE TREATED FOR TAX PURPOSES.

equipment purchases, employee bonuses, certain accruals, owner distributions, and additional estimated tax payments. It is imperative to start with a clean set of books that consider all known or potential adjustments. Understanding this amount allows a contractor to work backward to ensure all financial goals are met while considering the related income tax effect.

Based on the projected taxable income, should contractors consider purchasing additional assets by year-end to minimize taxable income? For equipment-intensive contractors, depreciation deferrals are the most common way to minimize tax liability. It is important to understand the amount of depreciation added back to taxable income in the current year from prior year deferrals (this should be considered in the question regarding deferred tax items that will turn around in the current year from the prior year, as already discussed). Contractors often have a wish list of equipment they need to buy. Using this list at year-end to methodically purchase equipment and minimize tax liability is a highly effective tax reduction strategy. A contractor should be mindful though, as this will likely affect working capital. A contractor would not want to reduce their income tax liability at the cost of negatively affecting the working capital amount needed for year-end. If working capital is the contractor's overall focus, buying a large quantity of equipment at year-end will reduce this financial ratio (either by cash payments or one years' worth of current maturities of equipment purchases based on the number of years financed).

In addition, there is a large variety of depreciation methods available, and choosing the correct method (on an asset-by-asset basis) can be vital to managing federal and state income tax liabilities. It is also very important to consider the state depreciation rules for the states in which the contractor operates. For example, if a contractor elects to use the 100 percent bonus method of depreciation in a state that does not allow bonus depreciation, the amount of bonus expense taken for federal purposes will be added back as income and taxed at the state level. If the contractor instead elects to use Section 179 of the Internal Revenue Service Tax Code (and take the same amount of expense), this amount may not be added back as income at the state level. Considering many state tax rates range from 6 percent to 15 percent, this can result in a large state tax liability for the contractor if not planned properly. Contractors should also consider the effects of their depreciation methods on future operating years. Accelerating depreciation in the current year will result in minimal to no deductibility in future years.

Does the company qualify for research and development credits? Under the current rules for research and development credits, many contractors can qualify. It is important for contractors to discuss this with a CPA to determine whether they meet the requirements and can benefit from the credits; otherwise, these credits could be a valuable missed opportunity.

What is the amount of distributions (bonuses) that should be taken by the owners? Owners of pass-through entities that pay tax at the individual level should discuss with their CPA whether a bonus or a distribution should be made, based on the effect it will have from a tax perspective. Defined in the tax code as a qualified business, contractors could miss out on the qualified business income (QBI) deduction, which provides a 20 percent deduction of taxable income from a qualified business, if the contractor makes a bonus payment to the owners instead of a distribution. It may be a better tax strategy for the owner to take a distribution to ensure they are not reducing the QBI deduction that will pass through to their personal income tax return.

These are just a few of the many questions to consider when talking to your CPA prior to year-end. It is also very important to communicate any items that have changed from the prior year and anything a contractor is anticipating or planning prior to year-end. Often, transactions can be planned or structured for the best taxable outcome if considered before the fact; however, there is little that can be done once a transaction has already taken place. ■