

ON-SITE

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Elliott Davis

Accountants and Business Advisors

www.elliottdavis.com

In appreciation of depreciation ...

Straight-line vs. declining-balance method

Straight-line depreciation is the easiest and, therefore, most popular method for determining what amount to charge against your construction equipment each year. But is it the best?

The declining-balance method has gained popularity in recent years among many construction businesses. Whether your company should switch from one method to the other depends, in part, on how much fluctuation you can tolerate in your annual owning and operating costs. Here's a comparison of the two.

Straight-line method

Straight-line depreciation is a function of time only. To determine the annual depreciation amount, you subtract the expected salvage value from the purchase price and then divide that number by the equipment's anticipated years of useful life. The result is your annual depreciation on the equipment.

Thus, if you expect a \$500,000 piece of equipment to be worth only \$50,000 after ten years, you'll depreciate it each year by 10% of the \$450,000 difference, or \$45,000. This formula

doesn't consider how many hours you use the equipment, what it costs to operate it, or what, if any, revenue it will earn from leases. It simply assumes a 10% decrease in book value every year for 10 years.

One advantage of the declining-balance method over the straight-line method is that, for income tax purposes, you may take a higher tax deduction in the early years of ownership.

While that's certainly easy to calculate, it doesn't match the expense with the actual physical use of the equipment. The income statement will simply reflect lower expenses in the early years when costs are low and higher ones later when operating and maintenance costs increase.

Declining-balance method

This approach accelerates depreciation faster than the straight-line method because it bases each year's depreciation on the equipment's previous-year net book value. This leaves more cash in the company because you're writing off for tax purposes a higher fraction of the cost early. (Bear in mind, however, that there is a difference between financial accounting and tax accounting — a distinction worth discussing with your CPA.)

On the equipment in the example, the normal double declining-balance method does not take into account the remaining equipment value at the end of the tenth year. The first-year depreciation would be \$100,000



[\$500,000 x 20% (double the 10% annual rate)]. The second-year depreciation would be \$80,000 [(\$500,000 less the prior year's accumulated depreciation of \$100,000) x 20%].

One advantage of the declining-balance method over the straight-line method is that, for income tax purposes, you may take a higher tax deduction in the early years of ownership. A disadvantage of this accelerated method in the early years, however, is that your balance sheets will reflect lower book values for equipment and company equity.

Mull it over

Finally, no depreciation discussion would be complete without a mention of the Section 179 equipment expensing deduction allowable under the Internal Revenue Code. It allows you to write off up to \$108,000 in 2006 for the acquisition of qualified property (subject to certain limitations).

How to charge equipment depreciation is an important accounting question that every construction company owner should mull over regularly — with the help of his or her CPA, of course. ↑

Bulk up your bonding capacity

Sureties need assurance that you're a good risk

You know what you're looking for in a surety company, but do you also know what a surety company is looking for in you? In a tightening economy, it pays to find out.

Remember that a surety's basic decision is whether you have the resources, experience, capacity and skills to perform as you say you will. And because this company will be essentially guaranteeing that you'll produce a dependable product, it's not surprising that the surety wants some guarantees from you.



But even more important is having a good reputation with owners, subcontractors, suppliers and others involved in your projects. Similarly, if your management team is well regarded in the industry, has a proven record of success and has enough staff to do the required work, sureties will be more comfortable that you'll be able to perform as expected.

Of course, you can't change how long you've been in business, and it takes time to build a reputation. But you can impress sureties in other ways. One is to have a well-thought-out, written succession plan — including buy-sell agreements or other mechanisms to facilitate a smooth transfer of leadership in case a key person dies or leaves unexpectedly.

Reputation counts

In making bonding decisions, sureties have always considered a construction company's history, experience, reputation, business structure, fiscal performance and leadership.

If you've been in business for some time, and have the records to prove that you regularly finish jobs on time, within budget and according to specs, you're in a good starting position. A history of financial stability and a tradition of sticking to projects that are best suited to your strengths are also important.

Money matters

Each surety has its own financial criteria for bonding construction companies, but every one will look at your net worth, the amount of uncompleted work you have on hand and your cash flow. They'll also be interested in your credit history, whether you have an established banking relationship and the condition of your bank accounts.

Make sure your accounting system includes appropriate controls and reporting capabilities, and try to eliminate significant swings in monthly performance. Sureties that once relied on quarterly statements to assess creditworthiness may now require monthly statements, and you'll need to stay aware of monthly cutoffs for recording transactions. You'll also have to do regular reconciliations.

If you're going to request additional surety bonding, work a little harder to keep your working capital healthy. Keep a closer-than-usual eye on receivables, because underwriters often take a dim view of those that are older than 45 days. Likewise, look at ways to reduce your debt. Consider options such as selling and leasing back equipment or changing depreciation assumptions to bolster your balance sheet.

If you know in advance that you'll need surety guarantees to win the contracts you want, you can identify areas where you need to improve and consult your financial advisor for suggestions on how best to address these shortcomings.

Finish first

In assessing your bonding potential, don't overlook your company's capacity to take on new work. A surety wants to know how much work you can

profitably add to your existing schedules and will look at your equipment, personnel and facilities.

While their evaluations are rather subjective, sureties will set bonding limits based, in part, on whether you appear to be overextending yourself. If you're working at or near capacity now, consider finishing some jobs before you seek bonding.

Finishing the work is just one part of closing the books on a project. You need to get paid, too. One of the best ways to be sure you do is to evaluate potential customers before you agree to do a job.

If someone has a reputation as being unusually difficult to work with or is consistently delinquent with payments and approvals needed to keep the job moving, you may want to look elsewhere for work.

Prove it

Remember, surety companies are guaranteeing that owners will be 100% satisfied with your work. In turn, you must satisfy the surety that you won't let them down. The best way to do that is to run a well-managed, profitable company that operates honorably and with integrity — and be ready and able to prove it. **T**

WILL DEFAULT INSURANCE DO?

Some contractors are turning to default insurance, rather than surety bonding, to protect themselves when subcontractors or suppliers fail to perform. Whether that's wise may be a matter of preference, but there are differences between the two.

If a subcontractor defaults, default insurance covers the cost of getting the work done, but you'll still be responsible for resolving any issues with the owner. Sureties help resolve the claim *and* make sure the work is completed.

Default insurance coverage generally extends up to 10 years after project completion; surety bonds expire within a year or two. Default insurance coverage covers only the amount the general contractor sets as the annual coverage limit; surety bonds cover every subcontractor that provides a bond. Last, default insurance pays claims without regard to contract prices, while performance and payment surety bonds pay the full contract price.

There are advantages and disadvantages to both types of coverage. On its face, default insurance is often less expensive than traditional bonding. But default insurance also imposes many exclusions and limitations that may ultimately diminish the protection that it appears to offer. Thus, you should carefully determine which is best suited to your company before choosing one over the other.

Changing of the guard

Succession planning tips for family-owned construction businesses

You've worked long and hard to build a successful construction business, but have you spent even a fraction of those hours thinking about what will happen to it when you're gone? If you're like most contractors, you haven't — and that puts your family, your company and your employees at risk.

The majority of U.S. construction companies are family-owned, and the average lifespan of a family business is just 24 years, says the Family Firm Institute. In most cases, this is because the owners have been too busy running the company to think about what will happen when they're ready — or forced — to retire.

And contrary to popular belief, the biggest threat to a family-owned construction business isn't estate taxes. It's that children or other family members will be unwilling or unable to pick up where the owner left off.

Start planning now

If you want to be sure your business will continue successfully after you leave, you'll need to draft a succession plan as meticulously as you carry out your building plans. And you need to start now, because succession planning isn't easy.

Unlike estate planning, which is essentially determining the distribution of assets through wills and other tools, succession planning involves people — people in the family, people in the company and, potentially, people outside of either.

You must ask yourself who is best suited to run the business when you depart, and what ownership transfer plan will treat you and all your heirs fairly. This includes knowing when you want to retire and how much income you'll need to do it.

Another critical component of a successful business transition is preparing the next generation to



take over. If younger family members are interested in construction, let them work for you in real jobs with real expectations.

Teach them to build projects the way you want them built, and teach them to run your business the way you want it run. And, if they genuinely can't cut it, give them a way out.

You can further reduce the chance of friction if you include your family in the succession planning process. Help them understand your values and goals for the business and listen to their suggestions.

Choose your tool

So how do you actually go about “changing the guard” at your construction company? The simplest way is to sell it, if family members can afford it and want to buy it. You can also transfer ownership by gifting it over time, but there are potential gift tax liabilities associated with this approach — and it won't generate an income stream to carry you through retirement.

A trust may be a better alternative for transferring ownership without creating harsh tax obligations. One option is a grantor retained annuity trust (GRAT), which will provide you with income for

a term of years and then distribute the remaining assets to your beneficiaries.

The transfer of assets into the GRAT is a taxable gift, but the annuity you receive reduces the value of the gift. A drawback, however, is that if you die before the end of the annuity period, the trust assets will be included in your estate and the tax advantages will be negated.

Whatever means you choose, put your succession plan in writing. Along with selecting a vehicle (or vehicles) to transfer your assets, state whether and how you'll stay involved with the company after you leave. If you try

to stay too involved, you may inadvertently inhibit your successors from succeeding. Then again, many former business owners stay on as consultants and are quite helpful.

Get help

You'll need professional advisors, including a CPA and attorney, to assist you with the financial and legal mechanics of transferring your business. A team that's familiar with both the construction industry and the often tricky dynamics of a family business can help you structure a succession plan that meets your expectations and preserves the longevity of your company. *T*



Futurescope: Construction Business Trends

Using telemetry technology to thwart theft

Construction job sites are notoriously attractive to thieves, and the days when chain-link fencing was sufficient to protect equipment are long gone. Unfortunately, nothing (not even 24-hour guard-dog patrols) will deter a really determined thief. But today's increasingly sophisticated security technology can help.

One example: telemetry, which is remote monitoring and communication technology that uses radio waves, satellites or other wireless capabilities to transmit information between monitoring units and computers.

To deter theft, you can use telemetry units to set operating curfews on your equipment. If someone tries to start a machine or moves it outside of the hours you set, the telemetry unit calls your cell phone or other mobile communication device. It also sends an electronic alarm message, or an e-mail, to your computer.

These systems are flexible, too. You can change the settings to accommodate work demands and access them from any Internet-enabled computer. Not only will telemetry discourage professional thieves, but it also can frustrate midnight "joy riders." Perhaps the biggest benefit of these systems, however, is that there are no cables or wires to install. Thus, telemetry technology is convenient to set up and difficult to circumvent.

If a piece of equipment does get stolen, a telemetry solution that includes a global positioning system (GPS) can help you retrieve it before it gets to a chop shop. GPS transponders mounted in the equipment tell you, via computer, precisely where the item is, any time of day or night. Logging in — or "pinging" the machine — gives you the address and mapped location. It's almost like taking the police to the thieves' front door without leaving your computer.

Telemetry systems do involve a substantial investment, though prices are decreasing as these solutions become more popular. In fact, some basic units go for \$500 or less, with more sophisticated ones costing a significantly greater amount. As insurance rates continue to rise, the value of protecting your equipment may be well worth the extra dollars spent.

The Contractor's Corner

How can I improve safety on my job sites?

I want to be sure my crews are working safely, but my company is small and money is tight. Most everything I've read about safety programs makes them sound too expensive for me. How can I improve safety on my job sites without breaking the bank?

First of all, recognize that money spent to prevent job-site accidents is money well spent — no matter how small the construction company. Along with keeping people and property out of harm's way, safe job sites improve morale and productivity. In addition, when you consider your potential expenses if a worker gets hurt or causes an injury to someone else, the cost of safety training and equipment becomes insignificant.

A good safety program can do more than limit your potential losses, though. It may actually save you money, because companies with good safety records can reduce their workers' compensation premiums — in some cases, enough to pay for the safety program itself.

Communication is key

The first steps toward improving job-site safety need not be expensive, but they must be consistent. If you don't have a clearly defined and well-communicated safety policy, you should develop one.

Let employees know what's expected of them and that you won't tolerate unsafe work practices.

Then schedule regular on-site meetings to reinforce the importance of safety and answer any questions employees may have. Topics can vary: You might address how to use protective gear or



operate equipment safely. Or you could discuss how to avoid falls, drive safely or lift properly.

Help is available

If you want to develop your own safety training program, a host of videos, workshops, Webinars, online courses, manuals and other materials are available. You can find them online or through government or trade associations, including the Occupational Safety and Health Administration (OSHA), National Association of Home Builders, and Associated Builders and Contractors.

As the owner of a small construction company, however, you may find that the task of developing a safety program is beyond your capabilities. Job sites are often too varied to make a “one-size-fits-all” safety training program of significant value, and you probably don't have the time, manpower or expertise to tailor your message to every job.

Thus, another option is to hire an outside consultant to help develop the safety training you need. You may also ask local Safety Council or insurance company inspectors to review your job sites and work practices, or send your supervisors to an OSHA safety training program.

Repetition is recommended

Regardless of how you develop your safety training, be consistent in repeating it again and again. And hold people accountable if they don't follow your procedures.

Last, you or your top managers should do monthly walk-throughs at job sites to identify issues that you need to add to your safety training regimen and to reinforce the importance of working safely. Let your foremen and workers know you're looking out for them. †

Davis Offers Unique Solutions to Complex Challenges



Shareholder Rick Davis has been with Elliott Davis almost 22 years and during that time he has developed a client base that includes contractors, engineers, developers, architects, and construction companies, each with a different set of demands. "Understanding our clients' needs is essential to providing the best possible services," says Davis. "For each complex client challenge there is a unique solution, and we do our best to provide that solution whenever possible."

As managing shareholder of the firm's Greenville – Spartanburg – Anderson offices, unique situations are nothing new to Rick, who also serves as an integral part of Elliott Davis' Construction Services Group, the firm's Executive Committee, and the Human Resources committee. Rick's professional experience includes communicating with management regarding areas of profitability improvement, coordinating audit and tax functions for clients, and providing business advisory services based on the needs of clients relative to their business cycles.

A Clemson University graduate, Rick is a CPA in South Carolina and is a member of both the AICPA and SCACPA. A Little League coach in his spare time, Rick spends most of his weekends at baseball and basketball games with his sons, Ricky, 15; Scott, 13; and Matthew, 10. He also is quite an amateur gourmet in the kitchen and he and his wife of 20 years, Deborah, often entertain friends with delicious selections of gourmet delicacies. To reach Rick, email him at rdavis@elliottdavis.com.

Cash: The Lifeblood of Your Business

All businesses fight cash flow problems, but it's particularly challenging for contractors. In fact, the Construction Financial Management Association notes that more contractors go out of business because of a lack of cash than because of a lack of profit. It's actually possible to show a profit and still not have enough cash on hand to support your business. Contractors face many reasons — besides unprofitable contracts — for their cash flow problems, including:

- Normal time lag between billing on a project and collecting the receivables
- Purchasing fixed assets from operating cash
- Labor-intensive work
- Paying suppliers or subcontractors before receiving payment from the related project
- Overinvesting in inventory
- Inadequate credit (i.e. working capital loan — line-of-credit), and
- Withdrawing money for outside investments or personal use

Contractors must work toward both contract profitability and successful cash management if they want to survive.

Improve your cash flow

You can improve your cash capability, increase cash reserves and enhance your company's borrowing power by using these strategies:

Bill smarter — Many contractors overbill, but if you overbill too much you may find yourself in a job borrow situation. Match payment of subcontractors with collections and know what needs to be paid with the overbillings. And, of course, never underbill.

Watch change orders. Work on getting change orders and claims quickly approved and ready for payment. To compensate yourself for this cost of cash, consider increasing your margins slightly on claims and change orders or any other payment that will be delayed.

Minimize inventory. Keep inventory (warehouse) levels at or close to zero.

Maximize financing. Obtain an adequate line of credit, and obtain long-term financing on new fixed asset additions.

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Get To Know Elliott Davis

Since 1925, Elliott Davis has been the accounting and business advisory firm that improves the financial management of emerging and middle market clients by personally applying national-caliber resources to a broad range of business services. Our mission is simple — help every client achieve the highest level of success and peace of mind possible. That philosophy has helped make us one of the largest CPA firms in the Southeast and among the Top 60 in the nation.

To learn more about Elliott Davis and how we can help you position your company for sustained profitable growth and continuing success, call us at 800-503-4721 or visit our Web site at www.elliottdavis.com.

Firm Services

In addition to offering personal and varied services to clients in a number of specialized industries, such as construction, Elliott Davis also provides deep collective experience in accounting and advisory functions:

- Tax Planning
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- Business Strategy
- Bookkeeping
- Business Valuation
- Litigation Support
- Cost Segregation Studies
- Retirement Plan Administration
- Wealth Management Services
- Technology Solutions