

CONTRACTOR UPDATE



Partners:

Greg Toman
 Cathy Booher
 Marvin Homan
 Mike Wardley
 Gregg DeVilbiss
 Mark Smith
 Jon Stangel

Well, here we are, heading into a contractor's busiest time of the year, at least we hope. When I say busiest, I should probably clarify. In the past, it used to refer to performing contract work. Now, I believe it relates more to bidding. It seems like a daily occurrence that I hear from a contractor, "I've never bid so much in my life, I have to, because I still can't get a job!" With no doubt, these times are tough, as evidenced by the decreased work available, increased number of contractors bidding a job, the increased number of out-of-town/out-of-state bidders on jobs, and low winning bids. And when I say low, it's the head-scratching, "how in the heck are they bidding it for that? They got to be losing money on it! There's no way!" kind of low. Sound familiar?

With that being said, one could expect the financial results for the first part of 2009 to be downright awful, right? Come on . . . there is **no way** anyone is making money in this economy, how could they be? At these margins? You're crazy, aren't you?!

Before I dive into that, let's take a look at our fall predictions/observations and suggestions for the end of 2008 and into 2009 to see how we did. To revisit these, visit our website at www.kentnersellers.com. In our last issue, we discussed the need to weigh tax planning versus balance sheet planning, reducing taxes or keeping the cash in the Company and making the bank and surety happy. Should companies pay out dividends or stockholder distributions as they have done historically, or should they maintain a higher working capital and cash balance? In addition, we suggested contractors take advantage of the downturn to reevaluate company expenses, the company's organizational structure, etc. We also suggested companies could benefit from being proactive, looking at different revenue levels and the effects on the

workforce, and to consider how many employees are needed if you're smaller. The downturn also gave companies an opportunity to analyze their lines of business or look into expanding into new areas. There was much that could be done.

Well, based on our discussions with contractors (both clients and non-clients of KS), it appears many companies did take the time to address the issues above. Most importantly, companies were proactive in looking into the future and determining profitable levels, whereas in the past, they may have kept workers on too long. There is no doubt our prediction that contractors would become the "swine flu" of the banking world would come true. Most of the financing world does not want anything to do with contractors in today's market. Which leads us to the questions I asked before, "no one is making any money, right? They are? You must be crazy! Well, **we're not crazy**. Financial results for contractors, for the most part, are relatively good. Yes, revenues are down, there is no denying that. They key is that contractors have done the things described above, resulting in profits on lower revenues. The contractors that have survived are leaner, meaner, and will soon be a little greener (talking \$ here, sorry environment!)

Marvin Homan, CPA, CCIFP

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CHANGES IN THE BANKING ENVIRONMENT - WHAT YOU NEED TO KNOW.

By: Jon T. Stangel, CPA, CCIFP



The banking and financing environment has certainly changed in the last 12 months. As a contractor, the effects are many. Financing matters that used to be hassle-free, now often require significant effort to get done, or can't get done. What changes are we seeing?

- ◆ A shift from demand and term debt tied to the prime interest rate, to an interest rate tied to LIBOR.
 - ◆ Rate minimums on variable rate debt. Your rate might be stated as prime minus 1%, but the ability to borrow at 2.25% is increasingly unlikely. Stated minimums of 5-6% may become the norm.
 - ◆ Monthly and quarterly financial statement requirements. This requirement has been included in line of credit agreements for years, but customers are now being held to it. It is important to be able to produce an accurate internal financial statement.
 - ◆ Closer monitoring of owner compensation, non-tax related distributions and dividends. It is the worst possible time to pull money out of your company for discretionary purchases, especially in conjunction with operating results being down. Understandably, banks (and bonding companies) want to see cash retained in the company during these difficult times.
 - ◆ Quarterly financial loan covenants. Historically, these have been included in previous credit agreements. However, often they were overlooked and calculated once a year at year-end. Also, it used to be easy to obtain waivers of such covenants in the past. Those days are over.
 - ◆ Closer scrutiny of collateral. The commercial real estate appraisal from five years ago and an updated estimated value from the owner is no longer enough to refinance.
 - ◆ Any commercial real estate or development debt is tough to obtain regardless of the variables. Some banks do not want to add to their current portfolio.
 - ◆ Information and contact. You are probably seeing increased contact from your bank. This is the directive your commercial lender has received. They are expected to be aware of your results well in advance of receiving the year-end financial statement.
- What can you do to steer your way through this new environment and maintain existing financing at competitive rates?
- ◆ Provide timely, accurate financial information as requested. You should have this information available for management's use anyway. Ignoring requests or masking poor results will quickly deteriorate your banking relationship. If operating results are ugly, meet with the bank and surety to explain what is going on and how things will be corrected.
 - ◆ Read and negotiate banking agreements prior to signing. Unfortunately, many times contractors are unaware of some of the covenants and clauses they are agreeing to. Trying to renegotiate a year later after a covenant failure is very difficult. Do not sign up for something that you will not be able to meet. Have your CPA review the agreement and run scenarios to determine whether you can meet the requirements if results are down. Negotiate covenants, don't just accept whatever is presented in the draft of the loan agreements. Be able to support your counterproposal and present why it makes sense.
 - ◆ As stated above, be aware of covenants and more importantly, plan appropriately to meet them. Often transactions and other activity can be structured to help meet covenants. Ask the bank to provide its covenant calculations using the financials from last year-end, and consider tracking them internally as part of your monthly financial statement reports.
 - ◆ Embrace the increased contact from your bank and surety. Look to them as another important advisor to your business. It is much easier for a bank or surety to terminate a relationship if the contractor has not done its part to treat the bank and surety with respect in terms of providing information and making them aware of issues.
- Unfortunately, construction has often been near the bottom of the list of industries that banks prefer to finance. Today is no different, and probably worse. Financial statements are often based on estimates, and the failure rate of contractors speaks for itself. Keep this in mind as you consider the above points and work to protect your banking relationship during these difficult times.

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LOCAL CONTRACTOR STATISTICS - HOW DO YOU COMPARE?



By: Bryan Brown, Senior Accountant

2008 brought many new challenges to the construction industry. Everything from maintaining bank financing and bonding capacity to dealing with the extreme competitiveness of the market and bids. While some contractors have been forced to close their doors, others are finding ways of ridding themselves of the fat and getting back to the basics. This has helped them survive in this down economy.

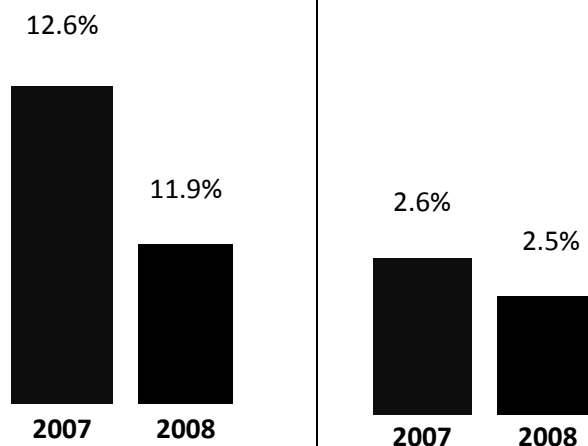
We wanted to again share with you some statistics from approximately forty of our contractor clients operating in the Miami Valley. These statistics represent various year ends ranging from March 2008 to December 2008. Overall in 2008, total revenues increased by approximately 6.7% over 2007 levels. Fifty-six percent of the contractors in the survey realized increases in total revenues from 2007 to 2008. Meanwhile, gross profits as a percentage of revenues decreased from 12.6% in 2007 to 11.9% in 2008 (a 6% decrease). Through discussions with our clients, the common theme of a very competitive bidding environment was the most significant factor in the reduction of gross profit. To help combat this decrease, companies had to find new and creative ways to cut operating costs. The contractors in the study were able to reduce operating costs as a percentage of total revenues from 10.0% in 2007 to 9.4% in 2008 (a 6% decrease). Overall, net income decreased as a percent of total revenues to 2.5% in 2008 from 2.6% for 2007 (a 4% decrease).

Total capital asset purchases (vehicles, construction equipment, office equipment, etc.) decreased 1.0% from 2007 to 2008. If it was not for the Economic Stimulus Act of 2008 and the related depreciation advantages, we would have likely seen capital expenditures significantly less than actual results. Due to the stagnant purchasing of capital assets and the decrease in net income, debt to equity levels remained consistent with 2007.

Average debt to equity levels decreased in 2008 from 1.7:1 in 2007 to 1.6:1.

Following the same trend, the total amount of balances outstanding on lines of credit at year end decreased 2.8% from 2007 to 2008.

With all the changes that occurred in 2008, no one knows what 2009 will bring. Will construction in the Miami Valley be positively impacted by the proposed stimulus projects? Only time will tell. For more information on how you stack up to the construction industry and your immediate peers, contact us at 937.898.1376.



Gross Profit Percentage as a Percent of Revenues

Net Income as a Percent of Revenues



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IRS AUDITS

Over the last year, we have witnessed increased activity from the IRS. We have had two corporations and three individuals undergo audits in the last six months. Although it is a very small sample, we can say that this level of activity is equal to the last three or four years combined. Discussions with auditors indicate that audit efforts are increasing and the Dayton region has been assigned additional audit personnel.

For corporations, the initial documentation request from the IRS focused on some of the following:

- ◆ **Request for corporate minutes.** The IRS looks to the corporate minutes for approval of major transactions, including, but not limited to:
 1. election of corporate officers
 2. approval of officer compensation, including bonuses
 3. approval of S corporation distributions and C corporation dividends
 4. changes to employee benefit plans, etc.
 5. capitalization policies for fixed asset purchases.



Corporate minutes are required by state law for all corporations (both S and C corporations). Consult your corporate attorney to obtain items that should and should not be included in your corporate minutes.

- ◆ **Compensation Add Backs** - The IRS looked at the vehicles the Company owned, who used them, and whether there was any personal use (including commuting). Except for some unique situations, an amount for personal use of company vehicles should be added to employee W-2s as compensation. For more than 2% S corporation owners, health insurance premiums paid by the Company should be added to the owners' W-2s as compensation.

- ◆ **Formal leases between related parties.** Leases should be formalized between operating companies and the leasing company, for example, an LLC that holds real estate or equipment. For equipment leases, be sure the lease and related invoices cover all equipment and vehicles that are being leased.
- ◆ **Substantiation of material owner participation in loss activities.** Without proper documentation, the IRS could recharacterize certain losses as passive, resulting in the losses being suspended in the current year.
- ◆ **Basis schedules.** For S corporations and their owners, the IRS has requested stockholder basis schedules supporting the deductibility of losses and tax-free distributions from the S corporation.

It is important to have the above in place and policies being adhered to. If not, the IRS may "dig in" for the long haul. Doing the little things now, may save you headaches down the road.

Traditional audit triggers we have seen include:

- ◆ Large losses from pass-through entities.
- ◆ Itemized deductions that are abnormally large for the taxpayers income bracket.
- ◆ Very large tax refunds.
- ◆ Profession of the taxpayer.

What are your chances of being audited by the IRS?

Historically, the chances of being audited are low. Income levels are one variable you can look at for historical audit activity. According to the Transactional Records Access Clearing House of Syracuse University, if you earned more than \$1 million, your chance of being audited in 2008 was about 6%, a decrease from 7% in the prior year. For those earning less than \$200,000 annually, you had less than a 1% chance of being audited in 2008.

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IRA CONVERSION OPPORTUNITY

By Gregg DeVilbiss, CPA, Partner



The Tax Increase Prevention and Reconciliation Act of 2005 contained a provision that will allow taxpayers opportunities for future planning and diversification with their Individual Retirement Accounts (IRA's) beginning in tax year 2010. Most IRA's are traditional IRA's meaning contributions are currently deductible and the earnings in the account grow tax deferred until distributions are made. The distributions from a traditional IRA will be taxed at ordinary income tax rates. Roth IRA's, on the other hand, are funded with after-tax contributions and earnings grow tax-free.

Under the current tax law, taxpayers' whose modified adjusted gross income exceeds \$100,000 are prohibited from converting their traditional IRA. Beginning in tax year 2010, the modified adjusted gross income limit will be removed. This will allow individuals to plan how future distributions from their IRA's will be taxed. Important factors to consider regarding a possible conversion:

- ◆ Upon conversion, you must pay ordinary income tax on the amount of the conversion (you do not have to convert the entire IRA account balance).
- ◆ A special provision applies to conversions in tax year 2010. Unless a taxpayer elects otherwise, the conversion is included ratably in income in 2011 and 2012. The related tax will be split between these two tax years.
- ◆ After conversion, future distributions from the Roth IRA will be **tax-free**.
- ◆ Many accounts are still suffering major losses from the recent stock market decline. A conversion in 2010 would result in less tax assuming the market does not have a major rebound.
- ◆ The result provides flexibility with future distributions from your IRA's.

Please consult your tax and financial advisor to further explore this opportunity.

CONTRACTOR TIDBITS

- ◆ The first time homebuyer tax credit will expire on December 31, 2009. The credit allows eligible first time homebuyers receive a credit up to \$8,000 on their tax return.
- ◆ *The American Recovery and Reinvestment Act of 2009* has extended the Section 179 deduction increases through December 31, 2009. The deduction limit is \$250,000 and the total amount of equipment purchased cannot exceed \$800,000.
- ◆ A new provision in *The American Recovery and Reinvestment Act of 2009* allows NOL's (Net Operating Losses) created during 2008 to be carried back (to get taxes previously paid, refunded) for 5 years rather than 2 years. Be sure to check with your tax preparer to see if you can benefit. The impact of this change can be substantial as the profitability of many contractors was greater in 2004 thru 2006, than in 2007 and 2008.
- ◆ June and July is a good time to review your 2009 year-to-date income and expenses to ensure your estimated tax payments and withholding are adequate to avoid underpayment penalties. If results are down, there may also be an opportunity to reduce estimated tax payments.
- ◆ Has your Company added on or built a building in the last 10 to 15 years? We may be able to help with a cost segregation study for tax purposes to accelerate depreciation deductions on the building and improvements.
- ◆ Remember to take credit on your Form 941 for any COBRA subsidy your Company pays under the recent change in legislation.

Financial and Tax planning are an important part of growing any business. Don't be left behind. For additional information or if you have questions, feel free to contact us.

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Kentner Sellers LLP

801 Falls Creek Drive
Vandalia OH 45377

Local Phone: 937.898.1376
Toll Free: 800.968.7725
Fax: 937.898.1516
Website: www.kentnersellers.com

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Other Items of Note

- ◆ Earlier this year, The Bureau of Workers Compensation recently approved a cap on premium increases that is expected to prevent unforeseen spikes in workers' compensation insurance costs. The capping plan is part of BWC's ongoing efforts to foster economic growth by stabilizing premiums and providing relief for small businesses that are striving to remain competitive in a difficult economy.
- ◆ The IRS standard mileage rate for use of a personal vehicle for business purposes is 55 cents per mile.
- ◆ For contractors, the workers comp weekly limit for non-officers for 2009 is \$1,151 per week.

Did you know:

- ◆ We can prepare business valuations to assist in succession planning, gifting, or divorce proceedings.
- ◆ We can assist you with year-end balance sheet and year-end tax planning.
- ◆ We can assist you in calculating your labor and overhead rates.
- ◆ We can assist you in determining what tax reporting methods are available to contractors and the impact of each method on your company.
- ◆ We can assist you or prepare your ODOT prequalification report.