

Equity statement

Current year	1,774,576
Comprehensive income	15,897

Dividends	23,853
-----------	--------

Previous year	1,606,630
Comprehensive income	19,327
Retained earnings	66,303
Dividends	67,676

CONTRACTOR

NOVEMBER/DECEMBER 2018

Cash flow statement

Operations	12,978,516
Earnings	12,873,892
Depreciation	104,624

Investing	2,372,535
Real estate	1,385,395
Equipment	4,439,118

Financing	3,505,981
	6,505,981

How sound are your financial statements?

Don't underestimate their inherent informative value

Don't let your company become a cyber target

In construction, dispute resolution is a many-splendored thing

Plus!

Construction Success Story

Preparing for a project owner's audit



CPAs & Business Advisors

17501 East 17th Street, Suite 100 Tustin, CA 92780-7924
(714) 505-9000 Fax: (714) 505-9200

HOW SOUND ARE YOUR FINANCIAL STATEMENTS?

Don't underestimate their inherent informative value

Many contractors labor under the false impression that financial statements are what their accounting software lists under "standard reports." Others believe that their in-house bookkeeper can draw up perfectly acceptable financial statements on demand. Typically, these notions are dispelled when those contractors apply for a performance and payment bond, or attempt to procure some significant financial leverage in the form of a construction loan or extended working capital for growth.

The moment a surety or commercial lender sees that a contractor is trying to submit in-house standard bookkeeping software printouts for financial statements, and that these reports aren't prepared by a CPA, the submission will more than likely be rejected. In turn, the surety or lender will ask the contractor to provide fully accrued and annotated financial statements that are compliant with Generally Accepted Accounting Principles (GAAP) and supported by schedules of work in progress, accounts receivable and payable, and a statement of cash flows.



Reasoning behind GAAP

All of this may sound like quite a bit of hassle to go through. But there's good reasoning behind the strict stipulations of these external parties.

Knowing what readers are looking for can help you understand whether your financial performance will be judged favorably.

In the past couple of decades alone, several large organizations have collapsed because their financial statements hid the fact that no real assets existed and no real revenues were being earned. GAAP prevents this by requiring disclosures. The thorough nature of properly and objectively generated financial statements gives bankers, sureties, investors and others a solid understanding of:

- What's being earned,
- When and how earnings are being used to operate the business, and
- Whether earnings are being retained to grow and sustain the business or distributed to owners as compensation or return on invested capital.

Financial statements also contain a notes section. These notes aren't like footnotes in a book or a random list of assumptions. Rather, they're disclosures required by GAAP to inform the reader:

- What type of company the contractor is running,
- The precise nature of the core business,
- How much revenue is generated from each customer type,
- What accounting principles are followed, and
- How assets and liabilities are calculated.

USING FINANCIAL STATEMENTS FOR STRATEGIC PLANNING

Properly prepared financial statements can prove immensely helpful for strategic planning. For example, say a construction company wants to procure more work under contract further into the future — say a year in advance — so that its backlog will look better to sureties and lenders.

Knowing that strong cash balances will raise the business's bonding capacity and make loans to finance future jobs easier to obtain, the contractor may want to invest liquid assets in an investment account so that his or her financial statements reflect a strong cash position.

If the contractor can keep \$100,000 in the investment account for no other purpose than to ensure future lending capacity, that \$100,000 is better not spent than spent. After all, if it's spent, he or she will have to replace the amount with earnings. But, if unspent, it can serve as a wellspring from which positive bonding and lending relationships can flow.

Financial statements should be prepared in accordance with GAAP unless a departure is warranted and disclosed.

Important insights

Indeed, financial statements are intended to be seen by outside parties. But knowing what readers are looking for can help you — the construction business owner — understand whether your company's financial performance will be judged favorably or if you'll need to undertake additional efforts to improve that performance to gain favorable attention.

For example, most banks want to see a solid liquid cash position on the balance sheet. Yet many contractors invest their cash in fixed assets and leverage their own companies' cash against future earnings growth. Maintaining a substantial cash reserve in a bank account, on the other hand, will put lenders and sureties more at ease and may soften their requests for bonding lines or extending lines of credit because the account shows them that the contractor values cash and understands its necessity.

Most banks also want to see positive cash flows. A cash flow statement prepared by a CPA clearly shows beginning cash and ending cash for each period, and what happened from the beginning of the period to the end to cause an increase (or decrease). This is most important in construction,

because revenues are so difficult to understand by financial statement readers who may be less experienced in revenue recognition models specific to this industry.

Other items of interest

Outside parties may look for other items of interest as well. Both bonding and insurance agents often want to see a schedule of cash receipts as part of the notes to financial statements. Such a schedule of cash receipts shows how much cash was received each period — be it a month or a year — by project or customer, and date.

Sureties tend to look closely at whether and how a contractor is developing and maintaining an adequate backlog. In simple terms, a backlog is a dollar amount of work under contract by the contractor for future performance. This is significant, as the backlog is the only work that can be truly relied on for future revenues because it's work *under contract*. Backlog is, thus, distinguished from revenue projections and sales forecasts.

Key role

Many construction companies start out using simple paper invoices and relatively inexpensive book-keeping software on their owners' home computers. But times change and, one hopes, the business grows. If your construction company is looking to reach that next tier of success, GAAP-compliant financial statements will likely play a key role. ■

DON'T LET YOUR COMPANY BECOME A CYBER TARGET

You may think your construction business is an unlikely target for cyberattacks. After all, hackers are more interested in organizations such as banks and retail chains that store the sensitive data of millions of customers, right?

Not necessarily. As the construction process grows more reliant on the Internet, contractors now store and share plenty of private and proprietary information that could make you a cyber target.

Data for the taking

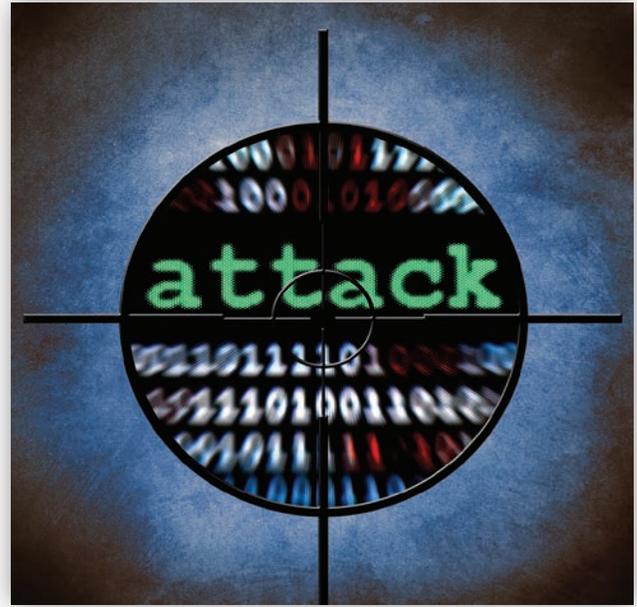
Besides seeking personal information on customers and employees, hackers could try to leverage a company's access to its business partners' confidential business information, intellectual property, or plans and specifications. Contractors, subcontractors, vendors and service providers all share access to networks and data that require protection.

Perhaps the most important part of any IT security plan is to keep all company software up to date.

In addition, though technologies such as remote monitoring and building information modeling may offer competitive advantages, they also make your company more vulnerable to cyberattacks.

Common types of cyberattacks

Today's cyberattacks go beyond simple theft. For example, as businesses that often wire transfer funds to vendors, construction companies can



be a target for funds-transfer fraud. Con artists monitor companies to identify their external partners and internal accounting personnel, and then impersonate a business partner and submit fraudulent invoices or payment instructions.

In some cases, attackers looking to steal commercially valuable information such as project bids or intellectual property will try "spear phishing" — that is, impersonating a key employee or known associate in an email and tricking the recipient into opening an infected attachment or visiting a malicious website. When the malware intrudes on company networks, it can allow a cybercriminal to gather data or disrupt operations.

Another form of cyberattack, which has become increasingly common, is the use of ransomware. This is "malware" (bad software) that encrypts critical data on affected systems. Once encrypted, the data is held hostage until the victim pays a ransom to recover the decryption key. Unfortunately, many

companies choose to pay the ransom rather than face the lost revenue and embarrassment of a public disruption of operations.

What you can do

Construction business owners can protect their valuable data in various ways, but the first step is to take cybersecurity seriously and address it formally.

For help getting started, consider the National Institute of Standards and Technology's Cybersecurity Framework. This is a tool for assessing any organization's preparedness to prevent, detect and respond to cyberattacks, as well as to plan for security process improvements. It's available for free at [gsa.gov](https://www.gsa.gov); search for "NIST."

Perhaps the most important part of any IT security plan is to keep all company software up to date. Cyber threats are an ever-evolving problem that

software developers are constantly dealing with. Whatever product you use, update it regularly to ensure new security holes are patched.

If your construction company is reaching a point where advanced technology is mission critical, you may want to hire someone who can concentrate on developing and maintaining security protocols. Otherwise, you could engage a consultant to implement measures such as strong passwords, and successfully guard against phishing emails and security breaches.

Position of strength

The fallout from a cyberattack can be devastating. You'll likely have to spend many months re-establishing your reputation and rebuilding relationships with project owners, vendors and others. Take preventive steps now while you're in a position of strength. ■

IN CONSTRUCTION, DISPUTE RESOLUTION IS A MANY-SPLENDORED THING

Those of a certain age may remember the old movie (and song) called "Love Is a Many-Splendored Thing." In the construction industry, there can be a decided lack of love on any given project if a dispute arises between your company and an owner or other party. In such situations, for better or worse, your options for resolving that dispute are also many-splendored — or at least many in number.

Entering dispute negotiations

Under the simplest option, two or more disputing parties meet to identify and discuss the issues with

the intention of arriving at a mutually acceptable solution. Unless an impasse develops, the parties are responsible for settling their differences without outside help. Negotiated settlements often end amicably because the parties are willing to cooperate to attain a mutually acceptable solution.

Turning to a mediator

With mediation, parties submit their dispute to an impartial mediator who coordinates one or more private proceedings to suggest a settlement. Although the mediator acts as a go-between, resolution ultimately rests with the parties — a mediator can't impose a settlement.

Mediation begins when either you, the opposing party or the presiding judge requests it. A court



may appoint the mediator, or you and the opposing party may select him or her through an independent mediation association. After selection, the mediator arranges the first meeting and clarifies the issues.

Going to arbitration

The arbitration process begins when parties submit a dispute to one or more impartial persons with construction-business expertise. The disputants may agree to the range of issues, procedures and scope of relief to be awarded. Arbitration hearings are usually private and less formal than court proceedings. Parties usually agree that the arbitrator's decision will be binding.

During the hearing, the arbitrators hear testimony and review submitted documents. When finished, the arbitrators issue a binding decision within 30 days. If you win, you present the award decision to a court, which will issue a judgment in your favor. Arbitration awards are binding and legally enforceable, but sometimes may be appealed.

Taking intermediate measures

Sometimes intermediate steps are needed. These can include:

Fact finding. This is a neutral third-party investigation of a dispute resulting in a written report and, usually, a recommended settlement. The report can facilitate further negotiations between the parties or perhaps bring about a previously overlooked resolution.

Conciliation. Here, a conciliator brings the disputing parties together to de-escalate heated disagreements. His or her role is to reduce the parties' inflammatory rhetoric and tension, open channels of communication, and promote continued negotiations.

Minitrial. This is a confidential, nonbinding information exchange between

disputants. The minitrial seeks to encourage prompt, cost-effective resolution of complex litigation by narrowing areas of contention, disposing of collateral issues and encouraging an equitable settlement.

Voluntary mediation/arbitration. Sometimes a neutral third party is selected as a mediator/arbitrator. Mediation/arbitration uses voluntary mediating techniques such as persuasion and discussion to reach a mutually acceptable agreement. But a mediator/arbitrator in some cases has the authority to issue a final and binding decision.

Ending up in court

Sometimes, it's impossible for parties to agree. Litigation begins when you or your opponent files a lawsuit in court. The court assigns the case to a judge, who holds a preliminary hearing. Both sides later file motions and the judge sets a trial date.

The judge or a jury will hear the case and hand down a decision or verdict. The losing party can appeal the decision to an appellate court, and whoever loses there can then usually appeal to the state's supreme court. As you're no doubt aware, given the attorneys' fees involved, litigation tends to be the most expensive option.

Check the contract

It's important to bear in mind that the contract in question may stipulate which dispute method must be used. So, review your contracts carefully and be prepared to approach conflicts with as much patience and knowledge as possible. ■

PREPARING FOR A PROJECT OWNER'S AUDIT

An asphalt contractor in a busy metropolitan area had specialized for years in paving small parking lots, golf cart paths and residential driveways. Now he was looking to expand into paving public roads.

As the contractor reviewed bid solicitations for some municipal road projects, he noted that the contracts provided for owner audits of the construction. This was something he hadn't encountered in his lump-sum contract work for private-sector clients.

He wasn't sure he liked the idea of giving an outsider access to his financial and other records. Before venturing to bid on a road job, he consulted with his CPA to find out what such audits might entail and how best to prepare for them.

What gets audited

His accountant explained that construction audits are standard practice for public-sector projects as well as large-scale commercial projects. The audits are required most commonly on projects that are delivered via contracts such as cost-plus-fee, cost-plus-fee with a guaranteed maximum price, and time and materials. That's because the risk to the owner is greatest in these arrangements.

Owners — particularly public agencies — may want to verify that the completion percentages reported and billed for are accurate. They also typically look for assurance that contractors are complying with safety rules, immigration regulations, small business and minority set-aside requirements, and prevailing-wage laws.

The audits often go beyond reviews of financial records to include jobsite inspections, the CPA warned. When inspecting a jobsite, auditors may look at materials to verify that all items meet



acceptable standards and match what's listed on customer invoices. Many check to see how hazardous substances on-site are handled, stored and disposed of. Some auditors even observe and report on how well safety procedures are being followed.

Provisions and documents

The contractor's accountant advised him to begin preparing for the possibility of a project audit by reviewing any contract awarded. It should spell out how often the owner can audit the job, what documents the contractor must retain, and how long records must be made available. Some contracts allow the owner to audit documents long after completion.

Beyond knowing the ins and outs of the contract, the CPA advised, the contractor should be sure he's producing and keeping clear, complete and well-organized financial records. Pertinent documents include job cost reports, subcontractor and supplier invoices, and daily activity and meeting logs.

Prepare yourself

On the bright side, the accountant concluded, such careful documentation can benefit a construction company even when not required for an owner audit. It can especially help him transition from smaller jobs to larger ones without losing track of expenses and risking severe slowdowns in his cash flow. ■



ABOUT HMWC:

How do you judge the strength of a professional services firm? At **HMWC CPAs & Business Advisors**, we believe two measures are relevant: the success of our clients and the quality of our people — the professionals who bring their knowledge, skills and experience to the engagement.

For more than 45 years, **HMWC CPAs & Business Advisors** has specialized in serving the financial and tax needs of privately-held businesses and their owners throughout Southern California. The depth and breadth of our experience — which includes such ancillary services as business consulting, business valuation, employee benefits and human resources services, estate planning and computer consulting — make us a valuable member of our clients' management team. At **HMWC CPAs & Business Advisors**, we are more than accountants, ***we are trusted business advisors.***

As a member of Integra International, we have both a national and international presence, which provides us with the resources to consult on a variety of multi-state and global tax and business issues. At the local level, the firm has a highly talented partner and manager group whose involvement on each account helps ensure that our client receives the necessary attention and personal service needed to effectively manage their business. *At **HMWC CPAs & Business Advisors**, our mission is to provide our clients, regardless of size, with a level of service and quality that is unparalleled in the industry.*



CPAs & Business Advisors

17501 East 17th Street, Suite 100 Tustin, CA 92780-7924
(714) 505-9000 Fax: (714) 505-9200