

Commercial Construction Accounting — A Powerful Sales Tool

By J.F. McCarthy

The downturn in housing construction has caused many to attempt transition to commercial construction. The change from residential to commercial is not just a change in construction types — it is also a change in accounting systems. Recognizing these differences in accounting systems is the essential to making the transition successful.

Residential owner occupied construction satisfies mainly personal preferences with some cost and financing considerations. Commercial construction satisfies business, investing, and tax needs with some consideration for personal preferences. Many residential and commercial accounting ideas are similar, but the purpose, need for communication, and level of detail are entirely different.

Understanding the tax consequences of depreciation can help sell a building that could not otherwise have been built. And understanding accounting is essential to win no-bid construction management contracts, and to perform publicly bid work requiring payment and performance bonds.

Accounting is an essential and valuable commercial construction tool. It is not hard to understand, and additional schooling is not required. The essential ideas to get started are described below.

Commercial property provides valuable depreciation tax benefits that homes do not

Depreciation for businesses (depreciation is not recognized for individuals) documents an asset's declining value over its useful life. Although the asset may still be in use, it may be worn out, functionally obsolete, or uneconomical to operate and maintain. A portion of this depreciation is subtracted each year from the asset's balance sheet value to reflect this reality, and as an expense from the income statement as well.

Legislation can also allow or mandate depreciation schedules unrelated to reality to induce favored behavior. In the mid 1960's, depreciation of the full value of the low-income housing multi-family residential projects could be depreciated at the time of construction, rather than a more reasonable 30-year life of the building. So a 20% down payment could produce a tax deduction of five times the cash paid. This caused those seeking tax shelters to finance projects they would not have otherwise have considered. A current example is the bonus (IRS classification 179) depreciation for equipment purchase. The \$250,000 per year maximum deduction has no relation to the useful life of the equipment — it is only a political attempt to stimulate the economy.

The real estate depreciation for tax is prized by real estate investors because it is an accounting, but not a cash, transaction. This permits the investor to receive cash from a project but shelter (receive paper tax deductions that wipe out taxable income) all of the income, and maybe more.

Understanding this dimension of a projects owner's needs can increase the contractor's ability to serve these needs.

Cost segregation pays big dividends and sells more projects

Cost segregation is an IRS accepted technique that accelerates commercial real estate depreciation for tax efficiency, which increases current cash flow. This additional cash can be used for the owner's personal

purposes, the operating expenses of the business — or to provide working capital necessary to refinance a loan, or for a new loan for facility renovation or construction.

This is accomplished by reclassifying parts of the commercial real estate (depreciated over 39 years for commercial, 27.5 years for multi-family residential) to personal property classifications (depreciated over 15, 7, and 5 years).

Maximum benefits can only be obtained for buildings with heavy mechanical, electrical, site, and cabinet work: veterinary hospitals, dental offices, human hospitals, restaurants, and manufacturing facilities. Cost segregation provides minimal benefits for other commercial construction, so almost no tax advisers are fully familiar with this technique. Acquired facilities, newly constructed facilities, tenant build outs, and renovations are all eligible.

Building owners have found the results of their cost segregation study highly beneficial. Some have been able to obtain new loans and begin capital expansions that would not have been otherwise possible.

Cost segregation studies require knowledge of tax law and cost engineering, so contractors probably cannot perform the study alone. But bringing a cost segregation specialist to the table as part of the construction service can enhance value. And the contractor's improved cost records can lower the cost segregation specialist's report cost.

These tax savings shape the building that can be built

Non-profit organizations — hospitals, schools, churches, and social service organizations find it far easier to raise capital cost for a new building than continually obtain required operating costs. Wealthy donors may contribute seeking building naming rights, but are unwilling to endow the janitor. And non-profits are not concerned with depreciation or taxes. This means non-profits may be very willing to consider and seek higher initial construction cost to achieve lower operating costs. Selling them a more efficient, but expensive, building may be what they want and need.

Multifamily residential is more balanced. Modest capital cost that produces low operating costs, and modest depreciation is the goal. Construction solutions to strike this balance are needed.

Commercial rental real estate, such as office buildings and shopping centers, frequently lease on a triple net basis (in addition to the rent, the tenant pays the real estate taxes, insurance, and common area maintenance and a portion of building repair). Here, extremely low capital construction cost is sought and high operating costs (since the tenant pays) are acceptable. These operating costs must remain within a normal standard for the area, or the real estate owner's reputation may be damaged.

Tax considerations make the non-profit building needs exactly opposite of the commercial rental real estate needs. Understanding these owners' very different accounting methods and needs helps provide the right building solution.

Negotiated construction management contracts require job cost accounting

Owners of single family residential homes are only concerned with the final total cost. Owners of commercial projects under the construction management delivery system are active participants in the construction management process, and seek to know much more. The answer to the question “what are we doing right now, how can we improve”, must be answered weekly with convincing accounting back up.

This requires job cost accounting. Weekly records separating labor, material, and subcontract amounts expended must be kept. These are then compared with the scheduled expenditures for these items, and the variations are noted and corrective procedures for the deficiencies established. The need to communicate this information to the owner and the frequency of the reporting make job costing for commercial construction more formal and rigorous than for residential.

This change is a significant effort but pays big dividends. A bidding contractor is just another name in the phone book slugging it out for the next job. The construction manager has a no-bid negotiated arrangement that promises a long-term continuously improving relationship with the owner. A continuous more even work volume is possible.

More rigorous accounting is required for commercial lenders and bonding companies

For larger multiyear commercial projects, the owners will seek to verify that the contractor has sufficient financial resources — credit, and tools and equipment to complete the project. This involves analysis of the accounting financial statements.

There are three levels of accounting statements. 1) A compilation simply states the accounting data in an organized format. 2) A review statement attempts some analysis of this data to determine that the accounting information is reasonable for the industry. And 3) the highest level, the audit, also seeks to verify that all assets such as equipment and accounts receivable claimed, actually exist. The higher level forms require both more work by the accountant, and more work and careful presentation by the construction company's owners.

Most government and many publicly bid projects require the contractor to furnish a payment and performance bond. The bonding companies will require one of the three forms of professionally prepared accounting statements, depending on the size of the project to be bonded.

Accounting tools for commercial project success are accessible to all

An understanding of the project owner's tax and depreciation considerations is a valuable contractor sales tool. Providing a building that both suits their physical building needs, as well as investment and tax consideration, can help win additional projects. And cost segregation can add further value.

Construction management project delivery demands more rigorous accounting and also job cost accounting. Satisfaction of these requirements can also help a contractor increase productivity and profit. And more rigorous accounting will be required to win larger projects.

Commercial project accounting is not just better paperwork — it is a different way of thinking and an essential tool for commercial project success — and is accessible to all.

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