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## Budget and Expense Issue

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### Why is Budgeting Important?

Estimating and matching future expenses to future revenue is very important because it helps business owners determine whether they have enough cash to fund operations, expand the business, and generate income for themselves. Without a budget or a plan, your business runs the risk of spending more money than it is taking in, or conversely, not spending enough money to grow the business and compete.

### Finding a Budgeting Approach: that fits *your* company.

Since every contractor's operating cycle is different and dependent on backlog, it is important to understand there is no "one size fits all" budgeting approach.

Effective budgeting requires customization and utilization of various techniques. Two frequently used methods are zero based and variable budgets. In both cases, the budgets are forward looking documents. They force you to think strategically about the future of your business. Effective companies examine how much cash they have to spend, their expenses, and how much profit they need to earn. The following provides a high level comparison of each technique.

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***Ciuni & Panichi, Inc.  
has been saving  
money for our  
construction clients  
by assisting with budgets,  
projections, and  
tax planning  
for over 35 years.***

# Finding a Budgeting Approach

## Variable (Flexible) Budget

This budget adjusts for changes in the volume of contract activity or revenues. A variable budget is built to adapt quickly to change versus a static budget, which typically remains at constant levels regardless of the volume of activity. This characteristic alone makes the variable budget very desirable for contractors.

This budgeting tool is not only effective for monitoring performance throughout the year; it is also very useful for planning purposes, specifically in “what if” scenarios. For example, if next year’s activity level doubles this year’s level, what will be the effect on the company’s cash, labor, subcontracting, and material supplies needs to support the increased revenues? Also, what is our expected profit? Overall, it is very important for management to have a tool such as a variable budget to assist in making good financial decisions.

## Zero Based Budget

This budgeting technique requires justification of all company expenses. At the beginning of each period, every major function within the company starts at a “zero base”. Analysis is then performed to determine the functional area’s overall needs and ensure they are aligned with the top level strategic goals of the company. Budgets are then built around what is needed for the upcoming period, regardless of whether the budget is higher or lower than the prior period. Like the variable budget, this mechanism can also be an effective budgeting tool.

In the end, zero based budgeting has its advantages and disadvantages. Many companies just don’t have enough resources to commit year after year to keep this extensive process going. One possible solution is the partial implementation of zero based budget or applying the zero based technique to certain discretionary fixed costs in a variable budget.

Either way, it is important that management stresses the importance of a budget throughout the organization. Placing importance on the budget gives the company an opportunity to control its own destiny and avoid unexpected results.

### Tips for developing a variable budget:

1. Estimate variable costs per unit of output, typically an hourly rate (i.e., labor, overhead, equipment, etc.)
2. Determine the estimated amount of fixed costs (i.e., debt service, lease payments, real estate taxes, mandatory capital expenditures, etc.)
3. Project the volume of output (based on contract revenues, billings, and backlog)
4. Build the variable budget based on the estimated cost information from steps 1 and 2 and projected contract revenues in step 3. Inputs can be changed for different scenarios. This type of budget works most efficiently in a spreadsheet that calculates automatically.

### Tips for developing a zero based budget:

1. Zero based budgeting is very time consuming and typically requires more resources than a variable budget.
2. Many companies will implement this technique over a series of periods in order to reduce the amount of resources necessary in the initial period.
3. This technique typically provides a clear link between budgets and strategic objectives.
4. This technique tends to favor functional areas that are easily identifiable as revenue generators.
5. It discourages blanket increases or decreases from the prior period budget.

# Business Expense Reimbursement: Two Options

Many companies reimburse their employees for business expenses they incur while performing their role as an employee, such as auto expenses, meals and entertainment, travel and lodging, etc. The type of plan the company has set up to account for these expenses can have a large impact on how the reimbursements are treated for tax purposes.

Here are two ways to account for these expenses:

## Accountable Plan

Reimbursements made to an employee under an accountable plan are not included in the employee's income, and the employee does not deduct the expenses.

An accountable plan must meet these requirements:

### Business Connection

The reimbursement must be for job related expenses that the employee would reasonably be expected to incur.

### Substantiation

The employee must substantiate the business expense by providing receipts or other documentation to the employer within a reasonable time period.

### Return of Excess Reimbursement

The employee must return any excess reimbursement to the employer within a reasonable period of time.

## What is a reasonable time period?

The following situations will be considered within a reasonable period of time for purposes of accountable plans:

- The employee receives an advance within 30 days of the time an expense is incurred.
- The employee adequately accounts for the expenses within 60 days of the time the expense was paid or incurred.
- Any excess reimbursement is returned to the employer within 120 days after the expense was paid or incurred.
- The employer provides a statement to the employee (at least quarterly) asking the employees to either return or adequately account for outstanding advances, and the employee complies within the 120 days of the statement.

## Nonaccountable Plan

Reimbursements made to an employee under a nonaccountable plan are treated as taxable wages and subject to all taxes. The employee deducts the expenses on their personal taxes using Form 2106, subject to the two percent adjusted gross income limitation on Schedule A.



## Our recommendation:

The most favorable tax treatment for both the employer and employee is to have an accountable plan. This way an employer can exclude business expense reimbursements from the employee's W-2 wages. Under a nonaccountable plan, the employer has to include expense reimbursement in the employee's W-2 wages, subject to all taxes. The employee has to report his/her employee business expenses on Form 2106 and is subject to limitations. An employee receives no benefit if they do not have enough deductions to itemize which is the case for many employees.

# Bonds and the Contractor

In a perfect world, contracts would be finished on time and on budget. Job costs would be incurred as planned and never be more than anticipated. Cash flow would remain steady and contractor defaults would never occur. Sounds great, doesn't it? Unfortunately, in the real world, contracts can finish late and over budget. Costs sometimes balloon at the least opportune time, and yes, contractors may fail.

Bonding requirements can be a major part of a construction contract. Public works require bonding by law and most commercial contracts require some sort of surety bond to guarantee completion. It is important to structure the finances of your construction company and the finances of a company owner favorably, so the prequalification process for a bond progresses efficiently.

The criteria for obtaining a construction bond are much like the criteria for obtaining a loan from a financial institution. A surety company wants to issue a bond for a company that has a good reputation and has the experience for the job in question. A surety needs to know if a contractor can meet its current and future obligations and has the ability to support the construction schedule by meeting equipment and payroll needs. Finally, the surety needs to know of a contractor's ability to borrow on a line of credit and the company's credit history.

If a contractor has limited history, or does not have the financial health to satisfy requirements, the surety may insist the owner of a company help meet the criteria outlined above. A personal financial statement is usually required in this situation, along with the owner's personal credit score.



## Commonly requested documents include:

- Organizational chart of key employees and resumes
- Financial statement and information
- Business plan – including descriptions on the type of work performed, the revenue level of common contracts, geographic operational area, and growth and profit objectives.
- Current work in progress and backlog
- History of largest completed jobs with contract details
- Continuity plan, key owner life insurance
- Evidence of a bank line of credit
- Recommendations and references

## The Small Business Administration

An owner's personal net worth may be enough to secure a bond, but if that is not enough, there is always the U.S. Small Business Administration's Surety Bond Guarantee Program. The SBA program guarantees bonds issued by sureties so that small and emerging businesses can obtain bonding. The guarantee can be up to \$2 million and covers bid bonds, payment bonds, performance bonds, and ancillary bonds. The guarantee requires the SBA to cover a portion of the losses incurred in the event of contractor default.

The program is only open to those companies that qualify as small businesses and to those that meet the surety's bonding qualifications. A small business is defined by the SBA as a business with average gross receipts over the last three fiscal years not exceeding \$6.5 million.

The construction industry is very competitive and it is important to put your best foot forward.

Contact Ciuni & Panichi, Inc. today to discuss how we can help you structure your business and personal finances to accomplish your goals.

**We are a team knowledgeable in and dedicated to the construction industry; contact any one of us at 216-831-7171.**

John Troyer and Brian Marita: Construction Partners

Jeremy Harrison and Kristen Schrader: Construction Audit Specialists

Alan Urbancic and William Schneider: Construction Tax Specialists