Testimony of

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on behalf of
The Associated General Contractors of America

Presented to the

United States Senate
Committee on Finance
Subcommittee on Long-Term Growth and Debt Reduction

on the topic of

Updating Depreciable Lives: Is There Salvage Value in the Current System?

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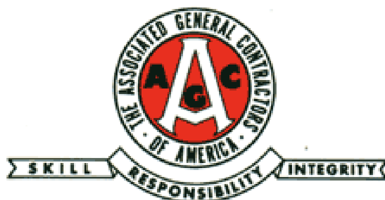

The Associated General Contractors of America (AGC) is the largest and oldest national construction trade association in the United States. AGC represents more than 32,000 firms, including 7,000 of America's leading general contractors, and over 12,000 specialty-contracting firms. More than 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters. Visit the AGC Web site at www.agc.org. AGC members are "Building Your Quality of Life."

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Thank you for this opportunity to present views on depreciation on behalf of The Associated General Contractors of America (AGC). I am Kenneth D. Simonson, AGC's Chief Economist. AGC is the largest and oldest national construction trade association in the United States. AGC represents more than 32,000 firms, including 7,000 of America's leading general contractors, and over 11,000 specialty-contracting firms. More than 13,000 service providers and suppliers are associated with AGC through a nationwide network of chapters.

Construction's Role in the Economy and the Tax System

Construction is a major force in the economy. The value of construction put in place—for residential construction, nonresidential building, and nonbuilding construction, or public works—totaled $1.03 trillion, or nearly 9% of gross domestic product (GDP), in 2004. The work was performed by roughly 700,000 construction businesses, employing 7.2 million workers. There were also 2.1 million "nonemployer businesses" in construction, roughly one out of eight such businesses in the country, making construction one of the largest channels for self-employment.

The industry also is a backbone of manufacturing. Census Bureau figures show that shipments of construction materials and supplies totaled $471 billion—nearly 11% of all domestic manufacturing shipments in 2004. Shipments of new construction machinery accounted for $29 billion, or 11%, of all domestic machinery shipments. Construction firms spent billions more on imported and used equipment. They also spent billions on vehicles, computers, and other equipment that are not classified as construction machinery but are integral to their business.

Because equipment, tools, and vehicles are so essential in construction, capital cost recovery rules—depreciation, expensing, tax credits, recapture, etc.—are an important aspect of the taxes contractors must contend with. Getting depreciation right for construction equipment and for assets used by construction firms is vital for all construction-related businesses—contractors, supplier industries, and building owners.

Although construction collectively contributes a lot to GDP and employment, most construction firms are very small. In 2002, more than 91% of construction firms had fewer than 20 employees. Only 1% had 100 or more, and just 457 firms (0.07%) had 500 or more.

Construction is a good route into business for many entrepreneurs, with relatively low barriers to entry. But the industry also has a high rate of exit. Census data prepared for the Office of Advocacy of the U.S. Small Business Administration shows that nearly 79,000 construction firms in 2002 did not have employees in 2001 and were presumably new businesses, while 81,000 businesses closed.

These facts suggest that most construction firms do not have the size or experience to be able to cope with complex or frequently changing tax rules. **A simple, rational, and relatively stable set of tax rules, particularly with reference to capital cost recovery, will enable small contractors to adapt and concentrate on building a strong economy rather than being forced to become tax experts.**

Current and Recent Tax Treatment of Construction Assets

MACRS. The Modified Accelerated Cost Recovery System (MACRS) includes a category called "construction assets," which can be written off over five years. Most other assets used by construction firms also are eligible for five-year write-offs: heavy trucks, such as dump trucks, concrete mixers and pumpers, and mobile cranes; light trucks, such as panel trucks and pickups used to transport plumbing or electrical gear, work crews, and supervisors; and computers and office equipment.

Used property has the same write-off period as new property, with the new owner using the purchase date and amount to start the clock running anew. Usually, write-offs are "front-loaded," or accelerated, to allow larger percentages of the cost or "basis" to be deducted in the early years, using the "double-declining balance" method of depreciation.

Sec. 179 expensing. Under Internal Revenue Code section 179, contractors (and other taxpayers) who buy no more than $400,000 of equipment in a year can expense (immediately deduct) up to $100,000 of eligible property. (Both figures are indexed for inflation after 2003.) This provision, which was raised to the current limits only for investments in 2003-2007, simplifies tax accounting for many small contractors but creates disparate treatment for those

whose investments exceed the threshold. Currently, the expensing option phases out at a rate of $1 for every $1 by which total investment exceeds $400,000, and disappears for investments that total $500,000 or more in a year. Furthermore, the limits will drop from $100,000 and $400,000 (indexed) to $25,000 and $200,000 (unindexed) after 2007, unless Congress extends the current limits.

Bonus depreciation. During 2002-2004, taxpayers of all sizes were allowed to expense 30% (later raised to 50%) of the cost of new equipment placed in service by December 31, 2004. This was known as "bonus depreciation," although the "bonus" actually represented greater acceleration, not an increment beyond the actual cost of the asset. Furthermore, states varied as to whether they allowed all, some, or none of the bonus depreciation on state income tax returns, further complicating recordkeeping and tax calculations.

AMT. Both C corporations and businesses that are taxed at the individual level, such as S corporations, partnerships, and sole proprietorships, must recalculate depreciation for alternative minimum tax (AMT) purposes, using a longer write-off period and/or less accelerated method than double-declining balance. This requirement forces businesses to maintain two depreciation schedules for federal tax purposes.

Taxpayer Views on Current Depreciation Rules

In response to the invitation to testify at this hearing, AGC conducted a quick survey by email. Contractors and their tax advisors were asked to answer four questions:

1) Does the depreciation schedule for equipment affect the amount or timing of your purchases?
2) Did the higher limits for expensing for small investors, or the temporary "bonus" depreciation in effect last year, make a difference in amount or timing of purchases?
3) Should the depreciation schedule ("useful life") be adjusted for any particular class of equipment you use?
4) Do you have any other recommendations or observations [for] the subcommittee?

The answers are summarized below. Verbatim responses are in the Appendix.

<u>Write-off period and method</u>. For the most part, contractors found that the **accelerated five-year write-off is a fair reflection of the life and decline in economic value of major machinery**. However, some contractors found that **hand tools and smaller equipment, such as pumps, generators, and tamps**, tend to be worn out or damaged beyond the cost of repair after less than five years and **should be written off over three years or expensed**. In addition, contractors (like taxpayers in many other industries) reported that their **computers and associated software are obsolete in far less than five years**. A few also recommended shorter write-offs for used equipment. (However, determining the tax treatment of an asset that comprises a mix of new and used components, or the status of an asset that is sold shortly after first being placed in service, could make such a change in law too complex to be desirable.)

<u>Tax influence on investment decisions</u>. Contractors and advisors had a range of answers as to whether depreciation rules affect the amount and timing of investment. Some said investments are based wholly or largely on expected need for business reasons; others said that the after-tax cost is important and depreciation does make a difference.

<u>Influence of bonus depreciation and sec. 179</u>. As for the temporary bonus depreciation, several stated that the bonus had led to more investment; some said it had led them to accelerate purchases to meet the expiration date; others said it had no, or minimal, effect on buying decisions. A few expressed a wish for continuation of the provision. One CPA said that limiting the bonus to new equipment affected clients' decisions whether to buy new or used equipment.

The only respondent who commented specifically on small-investor expensing said his firm had engaged in sale/leasebacks to keep its purchases low enough to qualify for expensing.

<u>Other recommendations</u>. An oft-repeated recommendation was to **eliminate the AMT**, **or at least the separate depreciation** required for it. Finally, two respondents asked for reinstatement of the investment tax credit.

Capital Cost Recovery for Pollution Control Equipment

Over the next several years, progressively stricter emissions standards will be introduced for <u>new</u> diesel-powered offroad equipment, including construction equipment. However, there is no requirement to phase out use of <u>existing</u> equipment. Because equipment lasts a long time, the

emissions reductions associated with new equipment will be realized slowly unless owners of existing equipment also reduce emissions.

The Environmental Protection Agency (EPA) has developed a Verified Technology List for diesel-powered equipment, which lists devices that achieve a demonstrated reduction in one or more pollutants for specified engine makes and models. But adding these devices, or repowering or replacing a diesel engine, is expensive. Contractors generally receive no financial benefit from the expense of overhauling their equipment.

AGC believes it is appropriate, therefore, to **allow contractors to expense the cost of purchasing and installing pollution-reducing devices** listed on the Verified Technology List. Such tax treatment would be consistent with that provided under Code sec. 179A (deduction for clean-fuel vehicles and certain refueling property) and sec. 179B (deduction for small refiners for capital costs incurred in complying with EPA sulfur regulations). By limiting the deduction to items on the EPA list, the environmental benefits would be maximized and the revenue loss minimized.

Depreciation and the Demand for Construction Services

Contractors seldom own the real property they construct. But they can be significantly affected by changes in depreciation rules meant to affect owners and developers. For instance, the introduction of the original Accelerated Cost Recovery System in 1981, which greatly shortened and front-loaded the write-off periods for buildings as well as equipment, helped instigate a speculative building boom. The boom turned to a bust after passage of the Tax Reform Act of 1986, which hit real property especially hard, bankrupting contractors as well as building owners.

Since 1986, Congress has continued to adjust the depreciation period for several types of real property. When these changes are undertaken not to achieve neutrality in investment decisionmaking, but to raise revenue, contractors are likely to suffer more than investors. Many investors can readily find alternative uses for their funds, but contractors who purchased equipment, hired and trained personnel, and undertook managerial expenses in the expectation of a certain volume of business, cannot switch as easily.

AGC therefore recommends that Congress **avoid stretching out the cost recovery for real property**. Conversely, temporary enhancements of real-property depreciation should be left in place for an extended period to be effective and to allow contractors to adjust. For instance, the shortening of write-off periods for leasehold improvements and restaurant property (from 39 to 15 years) that is due to expire at the end of 2005 should be extended for several years, not just one year at a time, as is frequently done with expiring provisions.

Cost Recovery and Tax Restructuring

The comments above have addressed the effect of current or recently expired tax provisions on construction. But this Committee may soon consider much more sweeping changes to the tax code. How should the concerns and recommendations above fit into either small-scale tax adjustments or a major overhaul of the system?

First, change is costly, especially for small businesses. Time that owners must spend learning about a revision in the law, evaluating their new options or requirements, and executing changes is time taken away from running a business. Furthermore, many businesses are too small and/or unprofitable to take advantage of tax "opportunities" or "incentives," particularly short-lived ones. Therefore, **Congress should resist most short-term changes or ones for which complexity outweighs the benefit delivered**.

Second, changes often have unintended consequences. Construction firms have incurred enormous expense complying with "percentage of completion" accounting rules. These tax rules were enacted to match income and expense for extremely long-lasting defense and aerospace contracts but were written in a way that applies to ordinary construction jobs that span more than one year. Because the projects are typically finished within two years, changes in tax liability quickly "wash out" in the second year, but not before contractors have paid a lot to their accountants. **Congress should allow parties time to comment on proposed tax changes before enacting them, so that the consequences can be anticipated as widely as possible and taxpayers are given time to adjust**.

Third, the after-tax cost of assets does make a difference. For instance, reducing emissions from existing construction equipment provides a benefit to the public but not directly

to the owner. **Congress should compensate owners who provide that public benefit by reducing the cost of emissions-reducing capital**.

Summary

The current five-year, accelerated cost recovery method for most property used by construction firms is appropriate in the context of an income tax. Exceptions for which shorter lives, or expensing, are appropriate include: computers and related software; small tools and equipment that tend to wear out in less than five years; and pollution-control devices added to existing equipment.

Short-term incentives have a high cost in terms of requiring small businesses to spend precious managerial or owner's time learning, choosing, and adapting to the new "opportunity." Most incentives should be enacted on a long-term basis. An added reason to eschew short-term depreciation changes is that states increasingly have "decoupled" or only partially adopted the federal changes, adding further complexity and confusion to an already over-complex system.

The alternative minimum tax causes expense and misery for millions of corporate and individual taxpayers. Elimination of this dual system should be Congress's ultimate goal. Most contractors would effectively be removed from the burden of the AMT if the separate depreciation calculation were eliminated. If that cannot be accomplished quickly, small taxpayers should be granted relief by steeply and regularly raising the floor for the AMT.

Appendix

Answers to AGC's Informal Survey Regarding Capital Cost Recovery for Construction

AGC asked contractors and their tax advisors, via email, to answer the following questions:
1) Does the depreciation schedule for equipment affect the amount or timing of your purchases?
2) Did the higher limits for expensing for small investors, or the temporary "bonus" depreciation in effect last year, make a difference in amount or timing of purchases?
3) Should the depreciation schedule ("useful life") be adjusted for any particular class of equipment you use?
4) Do you have any other recommendations or observations [for] the subcommittee?

Verbatim answers are as follows:

<u>Contractors' responses</u>

1) Not really
2) Not really
3) Yes, depreciation periods for computers and buildings should be shortened.

1) No
2) No
3) Currently, we have no problems with the useful life

1) NO 2)NO 3)NO 4)NO

My answer to your question number three, is that in the medical field, the rules stipulate a five year useful life for DME (durable medical equipment). My experience with acute care hospitals and private physicians since 1993 is that the market value (and therefore useful life) of DME declines by about 50% to 80% in the first 24 months. Similar to the computer you use at work every day, medical equipment technology advances at an incredibly rapid rate. Does the device still have utility? Yes. But, a year from now, it won't perform as well as newer units with more advanced technology. As a result the value of almost-new DME plummets within a very short time. For example, one year ago, an ophthalmologist might have paid $125,000 for a new retinal camera. Here we are a year later, if that physician had to sell that camera today, he would be lucky to get $50,000 for it. Same for items like phacoemulsifiers and so on. Technology improves constantly, and nobody in a high-tech industry wants old technology. Especially when old technology means a higher risk of misdiagnosing a patient.

1 & 2) Equipment investment decisions in our business are based primarily on business/project needs; the depreciation schedules and the existence of bonus depreciation is only a distant secondary consideration. The tax depreciation schedules for equipment are relatively short and bonus depreciation is only shifting the write-off between years. If Congress wants to do something significant to encourage equipment investment it should consider the old investment tax credit.
3) The useful life classes for equipment are generally reasonable.
4) Tax Simplification!!!!
Congress needs to do something about AMT. The "normal/average" business or individual should not have to figure their taxes two ways. If we can't afford the loss of the AMT revenue, we need to adjust the regular tax rates to cover the loss. A business should have to figure its tax depreciation only one way - period. Our whole tax system is based on voluntary compliance; I believe simplification would increase compliance.

1) Yes 2) yes 3) Yes, computer servers

I always consider timing, any potential bonus depreciation and other tax rules when we purchase pieces of iron. Yes, indeed, it does make a difference. We try to look at the economics of any acquisition first, but, tax consequences are a close second. One suggestion I have is that small pieces (I would define them as costing less than $5K such as small pumps, generators and the like) should be depreciated over three years, not five. They simply don't last five years under tough conditions.

We used bonus depreciation for the purchase of a 210 tn crane. I think it would be useful if they took a look at simply expensing and eliminate depreciation for tax purposes. It would certainly have a positive short term effect. The long term tax would be the same.

1) The normal "long term – 7-10 year" depreciation is too long. Realistically our heavy equipment should be 5-7 years. Although the equipment will last longer, the productivivty and cost effectivnes falls off dramatically after 5 years. In addition there is more efficient equipment coming on the market; that makes our current fleet not as efficient as compared to the newer "stuff" out there. As a result we cycle our equipment out on a much shorter life than the depreciation life. This costs more, we have paid for it, but not been able to fully depreciate it.
2) ABSOLUTELY! The accelerated depreciation allowed us to buy probably $2,000,000 more equipment than we would have bought with out it.
3) AS stated above, yes. I think used equipment should also be afforded a reduced depreciation rate, say 20-30%.

The bonus depreciation helped considerably and did have an effect on our timing of purchases. We could better afford to purchase equipment by taking advantage of the accelerated depreciation expense at the end of the year. We would liked to have seen it last a little longer!

Well, first of all there is no question that the post-911 bonus depreciation had a huge effect on the timing and quantity of equipment purchases. I can speak specifically of my own experience at Ghilotti Bros. who are big equip purchasers and we accelerated many purchases and probably purchased more due to the bonus depreciation available. As far as the useful life affecting depreciation, certainly a more accelerated write off would have some effect, but with the current 5 year double-declining balance method available on most construction equipment, there probably isn't a whole lot more you could do there. I think the two biggest factors congress should look at are:
1) the impact of the alternative minimum tax. As I said previously, the 5 year DDB method provides a very reasonable economic recovery of asset cost that is not inconsistent with maintaining a productive fleet of equipment, but the fact that much of it can and does get stripped away when the AMT is imposed, can take a lot of the benefit away.
2) I still have fond memories of the old investment tax credit days. It seems to me that better than bonus depreciation and more accelerated depreciation methods the ITC is an ideal way to incentivize (is this a word) contractors because it is a permanent benefit not merely a timing difference. I wonder how many relatively unsophisticated contractors have been or will be hit with large tax liabilities once the bonus depreciation runs out and they realize in a year or two that they don't have any depreciation deductions left and, if their book income is down, will find themselves without the cash to pay the taxes due.

Yes.
IRS 5 year life on Computers is ridiculous. It should be half that useful life (24-36 mos).

The accelerated depreciation (ie. 50% in year purchased for new equipment) was the major reason that we purchased over 1.5 MILLION in new equipment in the last couple of years. I feel that this depreciation law had a lot to do with keeping our economy moving forward and also was a contributing factor to the success of many equipment suppliers and manufacturers. My company is just one of millions of small businesses that made investments in new equipment because of enhanced depreciation laws.
In most cases we finalized purchases of equipment prior to our 12/31 year end.
It would be beneficial to small business as well as to the United States economy to keep accelerated depreciation in place.

1) It was a consideration, but just one of several factors we look at
2) Yes, Since we typically exceeded limits, we did a sales/leaseback on enough of our equipment purchases during the year, so that we could take advantage of it.
3) Not a big concern

1) yes 2) yes 3) leasehold improvements should be more closely tied to the term of the lease - not 39 years.

1) Minimal impact
2) Yes
3) In current depreciation guidance, there seems to be no consideration given to whether a piece of equipment is acquired new or used. The “useful life” of a used dumptruck, backhoe, etc should be less than the 5 year asset class.

Capital Acquisitions are driven much more by anticipated need and expected utilization. Only at year end do we accelerate or defer acquisitions of assets for a temporary timing. The bonus Depreciation, has marginal impact on decision buying.
According to the most recent Construction Financial Management Association data, General Contractors, maintain a 1.7% margin before tax. For large capital acquisitions, utilization and justification of future need for the asset are much more important factors when deciding on a major acquisition.
Asset lives for most construction equipment are reasonable and acceptable. Larger heavy iron certainly has a much longer anticipated life than the 5 years allowed by the IRS, however, for contractors wishing to account for the longer life, different lives for tax and financial books would be an option that would allow for a more reasonable (longer) financial life for book while maintaining accelerated tax advantages allowed under current law.
The only real class of assets that the life seems unreasonable are Computer Hardware. The current 5 year life is far too short for an asset that becomes obsolete within three. As contractors get more automated and sophisticated, this continues to be an issue shared with the rest of the country.

Tax Advisors’ Responses

1) yes
2) yes
3) leasehold improvements useful life should be reduced. 39 yrs is not reasonable, particularly when lease terms often do not exceed 10 years. The 15 year life for LHI put in place by AJCA 2004 is much more reasonable, but is too temporary (placed is service dates between 10/22/04 and 12/31/05)
4) Continue increased section 179 limits. Is there anything they can do on the federal level to make it appealing for states to not decouple from the federal rules? The increased section 179 and bonus depreciation were great, but the states decoupling from these rules created accounting headaches.

The construction industry is effected by the useful lives that owners have for the commercial, residential and factory buildings they build. Lives of 39 years are not generally consistent with the useful economic lives of most buildings today. Too many changes are occuring that obsolete uses of buildings in a shorter period Accelerated methods align a proper matching of costs to revenues. Granted the physical facilities will most likely be there, but their use will most likely have changed. In short, real estate should have shorter, accelerated lives to match the economic use of the facilities-without penalty for using shorter or accelerated lives.

It is certainly my experience that bonus depreciation was a significant motivator in allowing many of my contractor clients to make purchases of equipment that they would not have not made at the time due to other economic concerns.

In answer to your questions, I believe the useful lives of computers should be reduced to 3 years. Rarely does a desktop or server last longer than that before it is obsolete.

As a CPA, I see several contractors, so would like to reply to your questions on behalf of them:
1) Yes - we consult with our contractors on a regular basis regarding the cost/benefits of equipment purchases including amount, timing and structure of transactions.
2) Yes - we have numerous contractors purchase equipment in order to take advantage of the bonus depreciation. We considered the cost of the equipment after taxes in order to evaluate the true cost of the equipment including the timing of the acquisition.
3) Not that I am aware of.
4) The impact of Alternative Minimum Tax resulting from depreciation methods for the small businesses.

1. The tax depreciation schedule does not affect the amount or timing of purchases.
2. Bonus depreciation did not affect purchase decisions.
3. Nearly all construction equipment is depreciated over a 5 year life, which is fair.
4. Eliminate AMT preference for construction equipment depreciation. Both methods use a 5 year life but AMT is based on 150% declining balance method and regular tax depreciation uses double declining balance

As a CPA working with a number of homebuilders and developers I can offer the following answers to your questions.
Yes, business owners do decide to make purchases to take advantage of certain depreciation incentives. The higher limits do and did make a difference in terms of both the timing and amounts of purchases that were and will be made.
Computer and technology equipment should have a shorter life than 5 years. 3 years would be more appropriate.
They should not use real property depreciation lives as a mechanism for balancing out revenue. Lets stick with the current system of 39 years commercial and 27 years residential.

I can provided some quick thoughts based on what I know my clients have considered. Some quick thoughts…….
1) It is a consideration and is planned when the company has a need for replace or add to it’s operating equipment base
2) Absolutely. Certain companies made decisions to acquire assets as a result of this bonus depreciation and the pending expiration date .
3) Small equipment items and or hand tools that are required to be capitalized have a life that far exceeds it’s utility in most cases. Those assets are generally required to be depreciated over 5 years and often the asset is not useable for more than 1 or 2 years.
4) Eliminate depreciation AMT adjustments. In other words keep the methods and lives for deprecation purposes that same for AMT vs. Regular income tax

1) Minimal impact
2) Yes
3) In current depreciation guidance, there seems to be no consideration given to whether a piece of equipment is acquired new or used. The “useful life” of a used dumptruck, backhoe, etc should be less than the 5 year asset class.

My thoughts are that the depreciation system is a record-keeping nightmare. Between books, tax, AMT, ACE, State, etc., my clients are paying a lot of money to someone to account for what is essentially a very simple process. Not sure if that fits in with your discussion, but wanted to pass that along.

1) Based on our client experience, the answer is yes. If a client is debating on whether or not to purchase a piece of equipment, the depreciation benefits are definitely a factor and in some cases, the main factor in determining when to purchase something.
2) Yes, this affected the decision of whether to buy new or used. Obviously, used equipment was taken out of the bonuse depreciation equation. Also, the fact that they received the accelerated depreciation was also a huge consideration, as to whether or not to buy a piece of equipment. The 6, 000 lb original rule for vehicles in relation to no limit was very effective in getting many large SUV's, Hummers, etc on the road in the last couple years. Obviously, that has now been minimized. The real benefit for the

bonus depreciation was for equipment intensive businesses (i.e. heavy highway contractors, etc) that could now benefit, whereas they generally are not allowed to use the Section 179 because they purchase in excessive of the annual limits.
3) The useful life for most assets appears reasonable.

I am a CPA in public practice and am responding in relation to how my clients reacted regarding the new depreciation rules, etc.

<u>Other Responses</u>

Tax credits with equipment and with real estate are very helpful to stimulate the economy. Cost segregation is a good example of how important the fast write off is to businesses/ Also, sec/ 179 and the extra 50% for 168 focus on these issues. [professor]

1) It certainly does. Long depreciation times are risky -- I know how business is now, but not how it will be in 5, 7 or 10 years. An item that can be depreciated fully the first year reduces our taxes by 41.4%. The net present value of the same item depreciated over ten years is 28.5%. On a $100,000 equipment purchase, the difference eats up $13,000 that could be invested in my business.
2) Yes, both.
3) Computers and programming are ridiculous. We should get to expense them instead of depreciating them. Shorter is better for everything, though.
4) This is extremely important to small business, especially. In Kansas, it saves us on state income taxes, too. [supplier]

On your questions, no to all three. [supplier]

This is not a majority view, but in my small business with about $1.5 million annually in revenue, I would prefer a permanent tax change to be able to expense everything in the year I buy it. Amortization and depreciation just do not make sense for small business. You should be able to take the full purchase price as a cost in the year you buy it. The fact it is rendering value in subsequent years is much overstated, as technological obsolescence negates much of that. Furthermore, business is either booming (when you buy) or doing nothing, and in those do nothing year you don't need to take the costs of prior year purchases becasue they are not offsetting any revenue. [consultant]