On-Site

SPRING 2017

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THE CONTRACTOR'S CORNER

Could punch list software help us preserve profitability?

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No surprises

How to maintain an accurate contract schedule

Tracking the financial minutiae of your contract schedule requires great attention to detail. But do you know what else requires great attention to detail? Construction projects! In the hustle and bustle to win, work on and complete jobs, it's understandably easy to make accounting mistakes with your contract schedule or to simply lose perspective on the overall picture.

For these reasons, maintaining an accurate schedule of contracts is key to profitability. Contractors often reach the end of a financial reporting period believing they've turned a healthy profit. Unfortunately, after accounting adjustments, the profit margin turns out to be much thinner than anticipated. Fortunately, there are ways to prevent such unpleasant surprises.

Start with the estimate

Every job begins with an estimate and, from a profitability perspective, every project ends there, too. Overly optimistic estimates could paint a rosier financial picture than the one that ultimately materializes because of delays and unforeseen cost increases. Then again, if you come in too low with estimates, you may win jobs but never reach your sought-after profit margin.

Finding the right balance is a topic for another article. What's important in terms of an accurate contract schedule is that you continually ensure that: 1) your estimate for each job reflects accurate, realistic costs to complete, and 2) your current projections show that you're on track for true profitability.

Of particular importance are estimated losses. It's one thing to lose a percentage point or two off your profit margin; it's another to actually lose money on a project. If your costs to complete are notably at odds with your estimate, the first order of business is to determine why and whether you can salvage the job.

If losses can't be helped, you've got to apply the proper accounting approach to the situation so you know precisely how the struggling project (or projects) will affect your bottom line. Under the percentage of completion accounting method, for example, you must recognize the full estimated loss of the project in the period in which you identify the estimated loss.

Put a system in place

As you may have gathered, to track how a project's costs are developing in relation to the estimate, as well as to generate accurate accounting data, you've got to have a system in place. Your CPA can help you set one up or review your current one, and the right financial management software is critical.

The precise data points you should track will depend on the nature of your work. But a solid billing and cash forecasting schedule should typically review items such as:

- Average earnings,
- Expected expenditures,
- Typical billing schedules,
- General financial effects of these types of projects, and
- Potential cost-escalating events.

Change orders are the X factor

You'll likely encounter many challenges while monitoring your contract schedule. Among the greatest, however, are change orders. Sure, these represent opportunities to increase the value of a contract. But they also represent uncertainty. Failure to properly account for the costs and revenues associated with this work can have a negative impact on a construction business's financial statements.

Suppose, for example, that you record costs attributable to a change order in total incurred job costs to date, without making a corresponding adjustment to the total contract price and total estimated contract costs. To a surety or lender, this may indicate excessive underbillings.

Another danger: You increase the total contract price based on out-of-scope work but can't secure change order approval. This situation can shake surety and lender confidence as profitability fades while the job goes forward.

Keeping track of these things will not only help you predict future earnings and cash flow, but also allow you to identify patterns and areas where you may be able to improve cash flow management across your contract schedule.

Integrate indirect costs

Another element of doing business that can throw off your contract schedule is indirect costs. Debate often erupts regarding the difference between these expenses and overhead. Generally, overhead refers to the costs of running a business — any business. Examples include rent, office equipment and supplies, salaries for executives and clerical staff, insurance, taxes, advertising and marketing expenses, and accounting and legal fees.

Indirect costs, however, are expenses related to a contract that aren't necessarily specific to one job. For instance, if you pay for activities such as project management consulting, purchasing, contract administration and safety oversight, these likely fall into this category. The costs of repairs and maintenance to equipment not specific to one project are also usually considered indirect costs.

A spike in indirect costs can negatively affect profitability estimates. Maybe you're working on a number of particularly complex jobs that call for more outside consulting. Or perhaps bad weather has put undue stress on vehicles and equipment, necessitating more repairs. If you neglect to account for such costs, or do so incompletely, surprising cost overruns within your contract schedule may result.

In addition, rare is the construction company whose indirect costs remain at minimum levels. So, as you track these expenses, distinguish which ones are fixed and which are variable. You may be able to trim variable indirect costs, improving your overall financial position.

Keep an eye on the big picture

It's easy to get overly focused on the details of one or two projects — especially if those jobs run into trouble or are more complicated than your other work. But keeping an eye on the big picture provided by your contract schedule is essential to preserving a healthy bottom line.

Hire when ready

Thinking outside the box and tracking costs

A skilled worker shortage continues to plague the construction industry. Because a quick solution isn't forthcoming — particularly if a flood of new infrastructure projects hit — you've got to think outside the box when it comes to finding workers.

You also need to be ready to absorb the costs of new employees, so it's critical to fully understand and closely monitor your labor costs.

Ideas to consider

If finding skilled labor is a challenge, there are things you can do. One of the most important is to take steps to retain existing employees. Consider initiating an ongoing retention program for your key employees and top performers. You could start by surveying employees about what keeps them with your company, why they might consider leaving, and what would make them happier. Also coordinate exit interviews that tell you why a worker has decided to leave.

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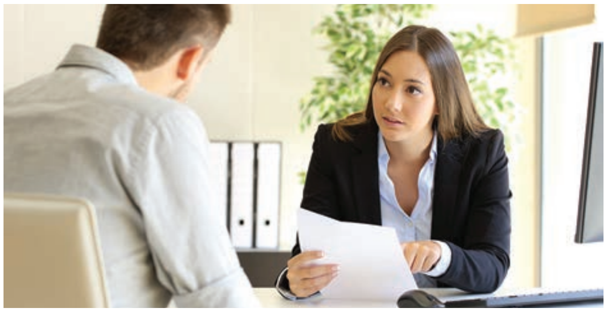
You may also want to expand your usual hiring pool. By soliciting job candidates who are veterans or food stamp recipients, for example, you might both find good employees and qualify for the Work Opportunity tax credit. This tax break is available to employers that hire individuals who are members of these and other "target groups." (Ask your CPA for details.)



Another idea: Engage independent contractors to fulfill certain roles. Being a contractor yourself, you understand that such workers come with little tax liability for you and no benefits costs. But, as always, be careful.

If the IRS reclassifies an independent contractor as an employee because it finds that you have too much control over the worker, you could owe back taxes, interest and penalties in relation to taxes you should have paid as well as to those you should have withheld. So if you really need to control a worker's schedule and train him or her a specific way, this may not be the best option.

Every employee expense

Before you expand your workforce, ensuring that you can afford to do so is a must. This means knowing the true cost of an employee. The most obvious cost is his or her salary or hourly wages. But take-home pay is only a fraction of total compensation costs for full-timers and others who qualify for benefits. A typical benefits package includes health insurance, retirement savings plans, and long-term disability and life insurance.

Break down these costs for each employee and add them to their respective salaries or wages.

Then factor in other contributors. Paid time off, for example, can be a good way to draw quality hires but may also hurt productivity if too generous.

Miscellaneous expenses affect labor costs as well — initial and ongoing training, uniforms or protective gear, and special technology are just a few examples. And don't forget payroll taxes.

Again, keep running totals of these amounts in the event you gain the opportunity to add a skilled laborer. This information can also help you immediately assess the impact of an employee's departure.

A fighting chance

The shortage of skilled construction workers certainly isn't making life any easier. But keeping a close eye on your ability to hire, while you explore alternative possibilities for acquiring good employees, can at least give you a fighting chance.

Bidding made better with go/no-go analysis

To bid or not to bid? For contractors, this is *always* the question. When times are tough, you may be tempted to bid on anything and everything. During a more stable economic climate, however, you can and perhaps should be as selective as possible.

How to make this critical decision is the question beneath the question. One way to decide whether to bid on a prospective project is to conduct a go/no-go analysis. This process has been applied for years by the U.S. military, as well as in engineering and software development. It can work for contractors, too.

Find your sweet spots

Under the go/no-go approach, you first determine the categories that should be evaluated to define a typically "good" project for your construction company. For example, you've often turned a profit on this type of job, encountered few if any financial or legal disputes, and have done strong work. Common categories include:

- Type of construction (examples: homebuilding, commercial, health care),
- Estimated project revenue (for instance, $5 million to $10 million),
- Delivery method (such as conventional bidding or design-build),
- Geographic area (could be a region, neighborhood or proximity to company headquarters),
- Customer identity (for example, a specific developer or commercial entity), and
- State of backlog (that is, heavily or lightly backlogged).

From there, you assign points to each category ranging from, say, 5 for "definitely a go" down to

1 for "definitely a no-go." The objective is to create a cumulative score that tells you whether the project in question is truly worth a bid.

To come up with the categories and scores, you'll need to look to historical knowledge of your company and its projects. Don't hesitate to gather your more experienced managers and employees to help you recall key details about where you've performed best. You might also use benchmarking to establish "sweet spot" areas for similar construction companies in your area.

Score yourself

Here's how a go/no-go analysis might work. Let's say George owns a general contracting company that primarily builds and rehabs multifamily housing projects but has also worked on some single-family homes and even a couple of smaller commercial jobs.

For simplicity's sake, we'll say George and his management team come up with three of the six previously mentioned categories by which to assess forthcoming bids:

1. Project type,
2. Estimated project revenue, and
3. Geographic area.

Because multifamily housing jobs are the company's focus, those types of projects would likely rank a 4 or 5 in the go/no-go analysis. Building a single-family home or working on a manageable commercial project might rank a 3; other, less familiar, jobs would probably rank a 1 or 2.

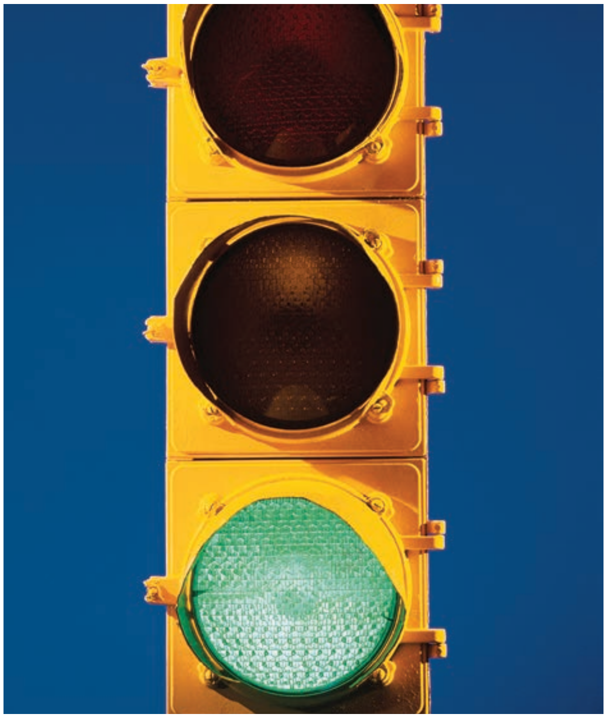
Historically, most of George's company's projects have had estimated project revenues in the $4 million to $6 million range. So prospective jobs that fall in that range would likely be ranked a 4 or 5, while larger projects (which may stretch company resources too thin) or smaller jobs (which may not be worth the effort) would rank lower.

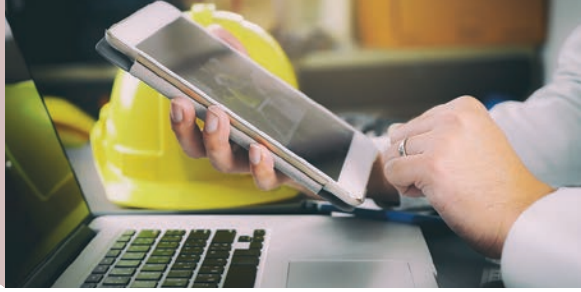
George and his managers decide to rank geographic area using concentric circles of miles. Because lower fuel costs and travel times are optimal, the closer a job is to the company's offices and equipment lot, the higher it will rank.

So if a project ranked 5 on project type, 5 on estimated revenue and 4 on geographic area, that's a total of 14 points, which would indicate a "go." A different job that amassed only, say, 7 points would likely be a no-go. A project that wound up somewhere in the middle, perhaps a 10, might call for further analysis to decide whether to proceed with a bid.

Make the best choice

The example above is greatly simplified. Go/no-go analyses can incorporate a multitude of categories and dozens of data points to arrive at an accurate ranking for each job being considered. The ultimate objective is to establish an objective, analytical means by which to decide whether a bid is truly worth your construction company's time, effort and resources.





Could punch list software help us preserve profitability?

I run a general contracting company. Several times recently, we've seen profits on a job take a last-minute hit because of confusion and mistakes in finishing off the punch list. One of my project managers mentioned that there's software designed to help contractors with the final stages of work. Is this true and, more important, is it worth the investment?

Indeed, the technology does exist. But whether you should spend money on it depends on the type of work you do and your existing technology.

Helpful images

Generally, these products fall under the heading "punch list management software." There are a variety of solutions on the market, but the overall goal is the same: to facilitate communication between general contractors and subcontractors working to close out a project.

With most apps, functionality begins with a camera — either a standalone digital one or the camera already installed in a smartphone or tablet. One or more team members simply photograph remaining work items on the job site and then add data to each image detailing:

- The nature of the repair or remaining work,
- Who should handle it,
- Where the specific building component is located, and
- What tools, equipment or additional labor might be needed.

This information is uploaded to a central website used by everyone involved in the project. Thus, much of the confusion over "who should do what" is eliminated. Plus, most systems automatically email the appropriate subcontractor, so there's less lag time between the identification of a punch list item and the resolution of the problem.

Considerations before you buy

Is such software worth the cost? For general contractors, the answer in many cases could be "yes." Speeding up completion and preventing punch list confusion helps preserve profitability, so the investment will probably pay for the implementation and maintenance costs fairly quickly.

That said, you may not need to buy a separate app for punch lists. Many of today's project management systems already have the built-in capability to produce shareable punch lists. So if you have such a system, look into whether you can get more out of its existing functionality.

For subcontractors, buying punch list software also may be unnecessary. In many cases, the general contractor should provide the means of viewing and tracking completion of the punch list. But, to that end, it's important for general contractors to encourage subcontractors to understand and use the technology in place.

Worthy exploration

For companies like yours that are struggling with effective completion, punch list software is worth exploring. Just be sure to set a sensible budget going in and consider the value of training and ongoing support.

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