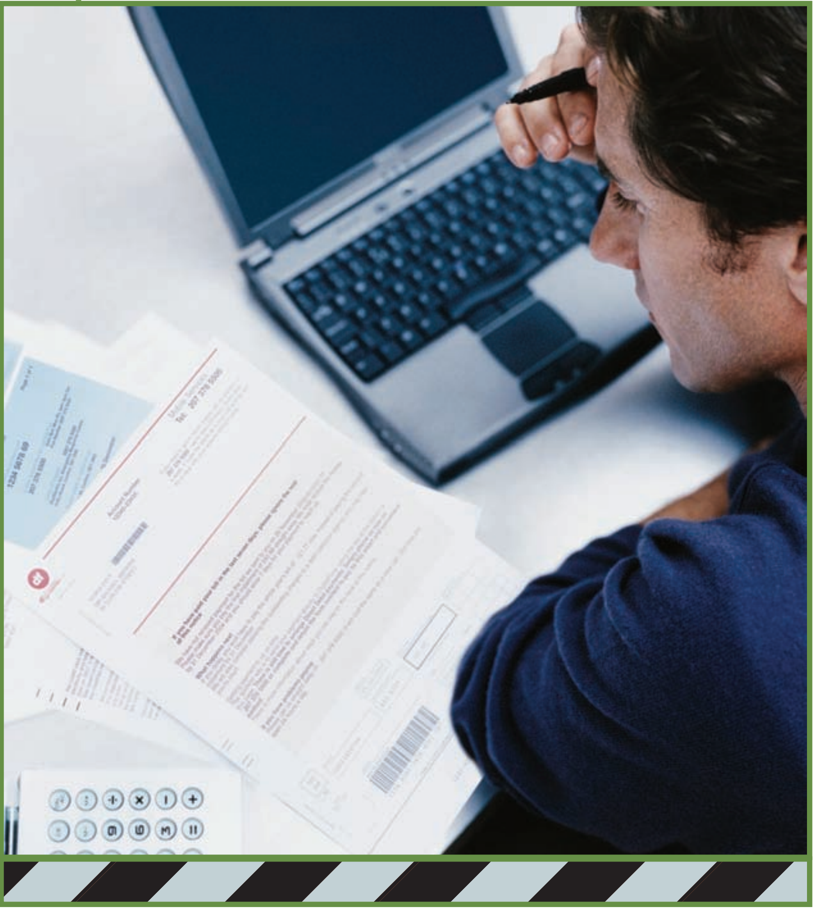
# Construction Industry Advisor



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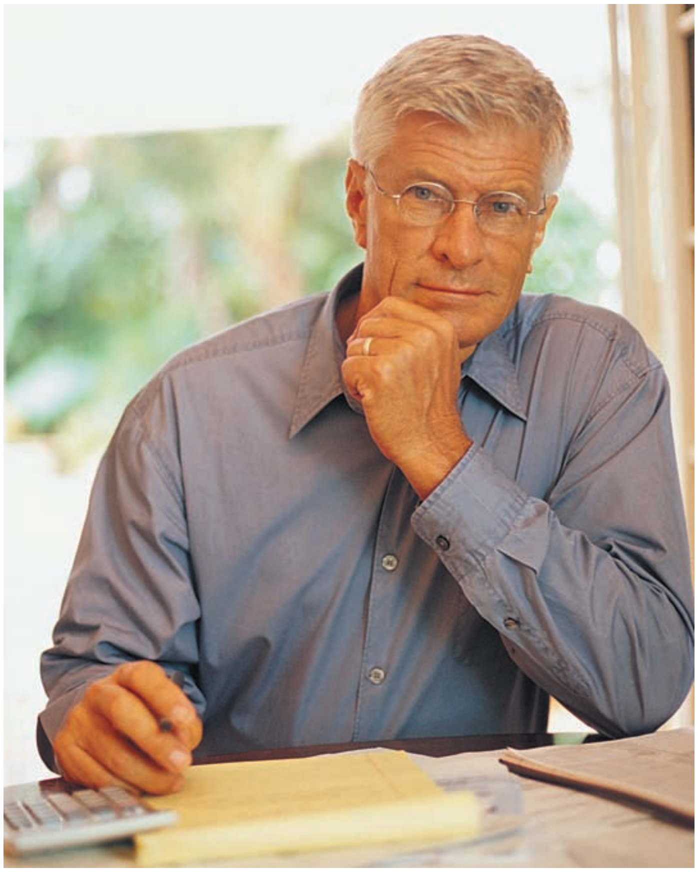
# Are you selling yourself short when calculating job costs?

A steady income stream is the foundation of a successful contracting business, but it isn't enough just to earn money and pay the bills. You must closely track and monitor job costs to submit accurate bids, remain competitive and avoid unpleasant surprises.

Too many contractors undercharge for their work because they fail to calculate the true direct and indirect costs of their construction projects, or they fail to keep costs under control after they've won a bid. Underestimating or overlooking costs can diminish profitability and make your business more susceptible to financial problems.

## Direct costs

Direct costs, which are relatively easy to identify, include labor, subcontractors, materials costs and equipment. Wages are a significant portion of labor costs, but the costs of federal and state taxes, workers' compensation insurance, health insurance, life and disability insurance, retirement and profit sharing plans, and paid days off can also add up.



One of the most basic ways to track direct costs is to assign every job a number and record that number with every cost incurred. On a more sophisticated level, you can use job-costing software to help you crunch the numbers with minimal effort and provide detailed profitability reports.

Remember, though, that the reports will provide little benefit if you don't use them proactively to better manage your finances. Profit and loss, job cost, accounts receivable and accounts payable are examples of key reports that should be reviewed each month. Look for places where you're over or under budget and adjust as needed.

## Indirect costs

How indirect costs are identified and allocated varies greatly between individual contractors, depending on the size of the project and the type of work being performed. Generally, though, contractors count project management expenses, safety supplies, small tools, training, appraisal and consulting fees, and shop and marketing expenses as indirect costs.

Construction-specific accounting software can help capture and report the right data and serve as a forecasting tool for future indirect costs. Experience counts, too. The longer your company has been in business, the more history it has to draw from in determining these expenses.

## Controlling costs

Keeping costs under control is one of the best ways to ensure you stay within your job cost estimate. Incorporating the following ideas can help you achieve your profit margin goal:

**Initiate early and frequent communication.** Change orders and costly delays often occur as a result of poor communication between owners, management and members of the project team. Get senior leadership involved from the beginning all the way through construction and punch list phases.

**Set a realistic schedule and stick to it.** Take into account unforeseen conditions (such as weather, labor strikes and delivery mishaps), additions or changes, and hold team members accountable for significant delays.

**Scrutinize project documents before starting.** Make sure everyone on the job reviews and understands all drawings, schematics and supporting documentation before construction begins.

**Confirm materials requirements up front.** If you're careful about making sure you have enough materials and phase deliveries adequately, your project will go much more smoothly.

**Staff appropriately.** Over- or underestimating the amount of labor needed to complete a project results in unnecessary delays and cost overruns.

**Consider innovative contracting methods.** Design-build or cost-plus-time bidding, for example, may help achieve overall cost and time savings.

### Count the costs

Tracking and controlling job costs pays off with significant benefits, but it requires constant effort to succeed. Doing so will enable you to get a better handle on the money flowing into and out of your company and helps you accurately bill for and collect all your costs.

### Accounting for claims costs

Even the most well-managed projects can have claims over work delays, project scope, acceleration orders, property damage and other issues. You should track claims costs separately from job costs because of the complex accounting principles that come into play when estimating damages.

Generally, there are three ways to price damages in contract disputes:

**1. The actual cost method.** This is used when you have detailed cost records for categories including labor, equipment, materials, home-office overhead and financing.

**2. The estimated cost method.** With this method, you need to calculate unabsorbed home-office costs.

**3. The total cost method.** This measures the difference between actual project costs and the estimate of the project's planned costs. The amount over the planned costs is considered the damage part of the claim.

Bringing a construction dispute to a successful resolution largely depends on the quality of project information and documentation. Whether you are asserting a construction claim or defending against one, linking the details of the project to the calculation of damages is critical.

## FIN 46(R) and what it means for contractors

Many construction companies are coming face to face with an accounting standard called "Financial Accounting Standards Board (FASB) Interpretation No. 46(R)." FIN 46(R) is an accounting principle, not a law. The FASB, which sets standards for companies' financial reporting, initially issued FIN 46 in January 2003 and later revised it in December 2003 with the hope of making balance sheets more accurately reflect companies' holdings.

FIN 46(R) has its roots in the Enron scandal, in which that company allegedly used off-balance-sheet arrangements to hide massive amounts of debt.

### What are VIEs?

FIN 46(R) requires a company's financial statements to include information about variable interest entities (VIEs), if the company is exposed to a majority of the related entities' gains or losses. A VIE is any "legal structure used to conduct activities or hold assets." In general, they include corporations, partnerships, joint ventures and trusts, and they often hold financial assets, including loans or receivables, real estate or other property.

As a result of FIN 46(R), many entities that were previously carried off balance sheet — which means they were hidden from view — must now be reported in a company's financial statements.

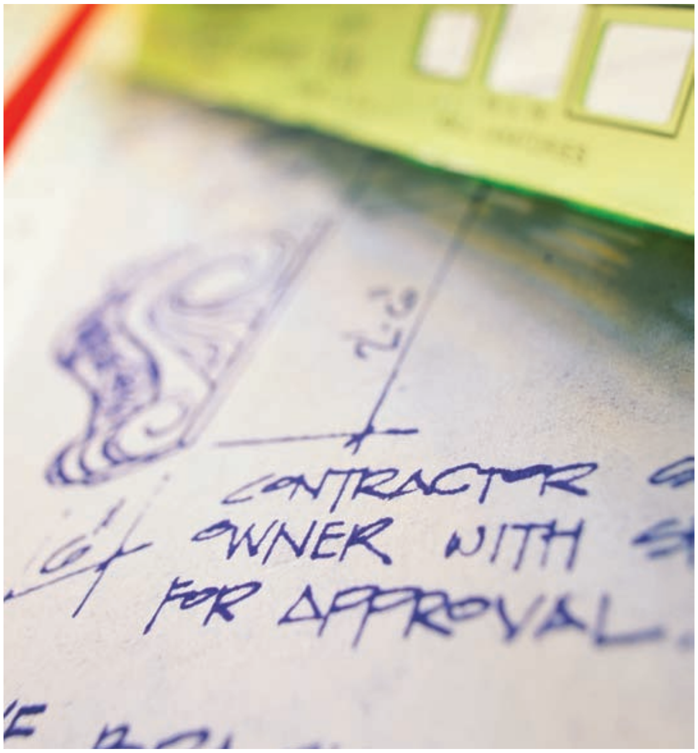
So you may need to report finances of entities you may not have included in your financial statements in the past. For example, if you have created a separately owned company for equipment leasing, real estate leasing, materials purchasing, land development, or a management company or similar venture, you may be required to disclose those entities' finances in your construction company's books.

Because just about any financial relationship could be subject to the provisions of FIN 46(R), you should review all financial relationships you have previously not included in your financial statements.

## Do you need to disclose everything?

If a VIE meets any of the following conditions, you must report it in your financial statements:

**Insufficient total equity investment.** If the VIE can't finance its operations without financial support from your construction company, this could indicate insufficient total equity investment. Equity of less than 10% of total assets is presumed to be insufficient, unless it can be shown to be otherwise. For example, if the fair market value of the VIE's real estate exceeds the book value, equity is greater than what's reflected on the financial statements.



**Equity holders lack controlling financial interest.** If the equity investors in the VIE have no significant control over it, don't bear the majority of risk, or don't share in the increased value of the entity, you may need to disclose the VIE.

*As a result of FIN 46(R), many entities that were previously carried off balance sheet must now be reported in a company's financial statements.*

**Voting or control rights are not proportional to risk.** This condition is met when the voting rights of the equity investors in a VIE don't match their exposure to gains or losses, and when major investment and financing transactions are conducted on behalf of individuals or entities that have disproportionately small voting interests. For example, if a contractor owned a 20% interest in a building partnership but was providing 100% of the debt guarantee, risk would exceed the voting rights of that contractor.

## Can you avoid FIN 46(R)?

Yes, by preparing financial statements without regard to generally accepted accounting principles (GAAP). Your accountant would then issue a qualified opinion indicating and describing the departure from GAAP.

This option isn't without risk, however. Banks and bonding companies may specify that GAAP is the only acceptable basis for financial statements and, as a result, may turn you down for loans, lines of credit or bonds. If you choose to go this route, discuss the potential ramifications with your bank or bonding company immediately.

## Should you seek advice?

Definitely. If your construction business has ownership, contractual or other financial interests in another legal entity, you should carefully evaluate whether FIN 46(R) applies to your situation. Your accountant or other professional financial advisor can help you better understand the complexities of this accounting standard.

# Employee performance reviews: Start now to save later

Did you know? According to the U.S. Department of Labor's Bureau of Labor Statistics, construction turnover rose from 23% to 25% between 2002 and 2003 — whereas, during that same time, turnover across other industry sectors within the United States remained stable at 20%.

While a two percentage point difference might seem small, the outlays can add up quickly when you add up the costs associated with employee turnover. Losing a single employee can cost your business between six months and one year of the terminated employee's salary in lost performance, plus the expense of recruiting and training a replacement.

So, how can you keep your employee turnover to a minimum? One way is to develop a performance review system that fits your company's culture and business needs.

## Reviews differ with company cultures and needs

There are many different types of performance review systems, each with their own strengths. They can range from a 360° evaluation to a simple, written statement from the project manager to the worker.

In a traditional hierarchical system, a performance review is generally based upon an appraisal of the employee's performance over the year based upon specific measurables, such as safety record, quality of work, timeliness of deliverables and communication. The specifics surrounding who participates in the review process, who performs the review and the measurables the company chooses to evaluate can vary from organization to organization based upon the company's business needs.

## Performance reviews may lower turnover

Performance reviews can reduce turnover in two ways:

**1. By correcting problems that could otherwise result in the need to dismiss an employee.** According to the Construction Financial Management Association's *2006 Construction Industry Annual Financial Survey*, 49% of employee turnover is due to termination for poor or inadequate performance. With regular performance reviews, you're better able to spot potential problems, allowing you to head off troubles in advance. The review is, in essence, a way to track an employee's performance in specified competencies so you can help the employee improve and perform at the level needed.

**2. By providing positive feedback and rewards that motivate your best employees to stay with your company.** Opportunities to praise stellar employees and document their superior work performance will help keep you from losing them to a competitor. Beyond giving your employees the added assurance of their value, reviews often improve overall employee morale, which, in turn, can improve productivity. And performance reviews that are tied to pay increases or bonuses can be even more powerful in improving motivation and, ultimately, retention.

## An added benefit: Reduced liability

As much as you want to reduce turnover, sometimes you have to terminate a poor performer for the good of the business. In such a situation, it's important to have documentation to back up the decision. Performance reviews provide a paper trail documenting persistent, subpar performance. This can help protect you if the employee sues you for unlawful discharge.

Performance reviews can reduce liability risks in other ways as well. For example, if one of your employees doesn't fully understand the scope of his or her job or your expectations of how the job should be performed, or doesn't possess the skills necessary to complete the job properly and safely, the ramifications can range from diminished profit margins to injury and even loss of life. Reviews can help you identify and correct problems before such negative consequences result.

### Get the most from your employees

Employee performance reviews can help your company make the most of your human capital and get a better return on your investment in training and developing your workers. An active evaluation and recognition program, tied to the employee's performance, is a great human resources tool that can have both an immediate and a long-term impact on your workforce and your bottom line.

## Contractors catch a break from Uncle Sam

Filing federal income taxes is never a pleasure, but it may now be a little less painful for contractors, thanks to the relatively new "manufacturers' deduction" that applies to construction activities. The deduction is a provision of the American Jobs Creation Act of 2004.

### Lower tax liability

The deduction is being phased in through 2010. It's 3% for 2006, increases to 6% for 2007, 2008 and 2009, and caps out at 9% for 2010 and beyond.

With each tax year, you may deduct the allowed percentage of your qualified production-related income or your taxable income — whichever is less. Qualified production-related income is essentially the revenue earned on qualified projects minus related costs and overhead.

An important restriction is that the deduction is limited to 50% of production-related W-2 wages paid by the company during the calendar year (or, for fiscal year taxpayers, during the calendar year that ends in the fiscal tax year). A company with $1 million of qualifying income, for example, will have to pay wages of $60,000 or more to claim the entire 3% reduction in 2006.

### Eligible activity

Contractors' qualifying production-related activities include construction and substantial renovation of real property, including residential and commercial buildings and infrastructure such as roads, power lines, water systems and communications facilities. To be "substantial," the renovation must be of a major component or substantial structural part of real property and must materially increase the property's value, significantly prolong its useful life, or adapt the property to a new or different use.

Architectural and engineering services performed in the United States and related to construction of real property are also eligible. This includes mechanical and electrical engineering contractors as well as general contractors.

The construction receipts from a single project can qualify as revenue for multiple contractors. In other words, revenue earned by both the general contractor and its subcontractors qualifies for the deduction for the respective companies involved. This treatment is different from that for other industries. For them, only one entity can claim the revenue derived from an individual project.

### Don't go it alone

Calculating the deduction may be a challenge if you're not used to dealing with tax laws. Plus, the IRS continues to issue new guidance regarding the deduction, which may not be reflected here. It's a good idea to consult with a financial advisor or tax consultant to fully understand the opportunities the new deduction represents for your business.

# Contractor's toolbox

## Bad bidding got you down?

## Master markups and margins for better bids

You've just hung up the phone with an owner's project leader on a building job you really wanted — really *needed* — to keep your construction company on an upward trajectory. But the news you expected to get didn't come; you lost the job to another bidder. You spent hours going over the numbers, but, according to the owner, your bid was way off target. What happened?

If you've ever experienced the sting of a lost bid, you know how baffling it can be. To effectively bid projects, you must not only accurately estimate job costs, but also have a keen understanding of markups and margins. Otherwise, you'll probably miss out on profit-making opportunities. (For more on estimating job costs, see "Are you selling yourself short when calculating job costs?" on page 2.)

### Markup

Markup is generally the leading method of calculating sales price because it's the easiest to do.

It all comes down to the simple equation: Job cost + markup = sales price. For example, a 20% markup on a $500,000 cost would create a $600,000 project. Therefore, you would charge your customer $600,000 for that construction project.

Your bid must be high enough to pay your bills and cover expenses such as labor, materials costs and equipment, while also generating a profit. Many contractors don't use high enough markups, fearing their prices won't be competitive. In cases like these, they may get the work, but end up with a very small profit margin, if they even make a profit at all.

### Margin

Margin is the difference between the sales price and your project costs — in other words, margin is your gross profit. You can set your sales price based on your target margin, but the math is a little more complicated, because a 20% markup won't yield a 20% margin. You have to inflate your sales price to reach your margin.

To illustrate, consider the 20% markup above. Your job has a $600,000 sales price, with costs of $500,000. To figure the margin, you subtract the cost from the sales price: $600,000 - $500,000 = $100,000 gross profit. But $100,000 / $600,000 is only 16.7%, not 20%. What's wrong with this computation?

If your goal is a 20% margin, you'll need to sell your job for $625,000 in order to reach it. The calculation would be $625,000 - $500,000 = $125,000 projected margin. Then: $125,000 / $625,000 = 20% margin.

### Do the math

The price you charge for your services can have a huge impact on the success or failure of your business. Charge too much and you may lose customers. Charge too little and your profits will be too low for long-term survival. The key is to know your market, your competition and your cost of doing business.

Determine the minimum markup or margin you're willing to take and adjust your bids accordingly. After all, knowing the financial numbers of your business is just as key to making money as getting paid for your work.

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