ON-SITE

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ElliottDavis LLC

Construction Services Group

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A wilted concept?

Retainage has outlived its purpose, study says

It's been a common construction business practice for decades. Owners view it as a way to ensure timely, problem-free project delivery. Contractors see it as a significant source of financial frustration.

We're referring, of course, to retainage — the practice of withholding a percentage of the contract price until a job is deemed complete and acceptable. In theory, it helps guarantee that you properly finish work per the contract. But in practice, retainage has long outworn its welcome, and, at least according to one recent study, it's doing more harm than good.

Costs go up

The study in question is a 2004 report issued by the Foundation of the American Subcontractors Association (FASA). One of the first problems it identifies is escalating costs. The study found that general contractors increase their contract prices by 2.2% and subcontractors by 3.6% when retainage is involved. Additionally, retainage reduces competition and negatively affects project relationships.

These results are hardly news to many industry insiders. Organizations such as The Associated General Contractors of America, Associated Specialty Contractors and The American Subcontractors Association have long been calling for retainage reform.

Legislators in many states have responded by capping the amount of retainage allowed, requiring the money to be held in interest-bearing escrow accounts, or mandating early or line-item release of the funds in some circumstances. A subcontractor who has completed all work on a project, for example, may be able to receive retainage funds before the rest of the job's completion.

While the construction industry as a whole has applauded these advances, many contractors still insist retainage should be abolished rather than reformed. Owners disagree, asserting that they need the practice to make sure defects are corrected and closing documents properly submitted.

Thank the British: A brief history of retainage

Retainage first became a part of the construction industry during the railroad expansion boom in Britain in the 1840s. At the time, people were starting construction companies expressly to grab a piece of the rail-building pie. Unfortunately, the pie wasn't big enough for everyone to have a slice, and contractors were going out of business before they could finish the jobs for which they'd been hired.

To protect themselves from this flurry of bankruptcies, owners began deducting 10% to 20% or more from payments. That way, they reasoned, they'd be covered if a construction company couldn't perform as promised.

The percentage withheld reflected the profit that owners presumed the contractors would eventually make from the job. And, the owners said, the builders didn't need this money to finish the work.

Timely payments go down

Owners and contractors most significantly differ on the amount of retainage that's eventually paid and the timeliness with which those funds are released. Owners firmly maintain that they pay retainage in full on every contract and as soon as possible.

But the at-risk construction managers, general contractors and subcontractors who responded to the FASA survey beg to differ. They report being paid in full only 90% (at-risk construction managers and subcontractors) to 94% (general contractors) of the time. General contractors and subcontractors also observe lengthy delays in collecting retainage, though owners and at-risk construction managers say it's paid promptly on completion.

Moreover, owners believe retainage doesn't affect which projects construction companies choose to pursue, while a majority of general contractors (58%) and most subcontractors (85%) say they avoid retainage projects when possible.

Alternatives are available

What's perhaps most irksome about retainage is that it offers largely redundant protection for owners. Fund trapping and prompt pay legislation, as well as lien laws, all provide protection similar to or greater than that afforded by retainage.

Fund trapping allows subcontractors to notify owners if a general contractor doesn't pay them. The owner then withholds the amount due until the dispute is settled. Fund trapping differs somewhat from retainage but still acts as a withholding of funds to expedite conflict resolution.

Prompt pay laws vary. In some states, they require builders to pay subcontractors within seven days of receiving owner payment.

Another, less direct alternative is for contract partners to get to know each other better. General contractors and owners often prequalify subcontractors to a "preferred" list to help ensure work will be completed satisfactorily and conflicts resolved more easily.

Hope is not lost

When eliminating retainage isn't possible, don't lose hope. There are a variety of ways you can make it more palatable when negotiating a construction contract. These include, when possible, stipulating that:

- Retainage percentages will be equal for general contractors and subcontractors if both provide the same levels of financial security,
- Line-item release will determine when retainage is paid,
- Retainage will be handled consistently throughout a project rather than differently at various job stages,
- Change orders won't delay retainage payments,
- Retainage won't apply to subcontracts and purchase agreements of less than $10,000, and
- Retainage will be held in an escrow account that pays interest to contractors and subcontractors according to their respective shares.

Naturally, also ensure that any retainage terms an owner specifies comply with state law.

A new age may be dawning

Despite contractor dissatisfaction and the available alternatives, owners appear unlikely to budge on the issue of retainage anytime soon. Then again, as the FASA study and recent legislative initiatives indicate, a new age may be dawning.

ESOPs may be a welcome addition or ticking time bomb for contractors

If you've been reading up on employee benefits lately, you may have learned that more and more businesses are opting for employee stock ownership plans (ESOPs). And indeed, these arrangements can be a welcome addition. But construction companies aren't like other businesses — so is an ESOP really a smart move for a contractor?

Enjoy the advantages

The answer is an emphatic "maybe." ESOPs are qualified retirement plans that invest primarily in employer stock rather than more traditional assets, as other plans do.

What makes ESOPs particularly attractive is that they're not only a viable employee benefit, but also a tax-advantaged business financing or succession planning tool. This is because, unlike traditional profit sharing plans, ESOPs may borrow to buy stock from company shareholders or newly issued stock from the company — enabling the company to raise needed capital or the shareholders to cash out of some or all of their holdings.

ESOPs are not only a viable employee benefit, but also a tax-advantaged business financing or succession planning tool.

You can fund the arrangement in one of two ways. First, in a "leveraged" ESOP, the plan obtains a loan from a commercial lender and uses the funds to buy stock in your company. The company contributes cash to the ESOP every year to service the loan, and stock held by the ESOP is released to participants' accounts as the loan is repaid.

Meanwhile, the company gets an income tax deduction for all contributions used to pay interest on the loan and may deduct amounts used to make payments on the loan principal up to 25% of the covered payroll expense.

Second, under a "nonleveraged" ESOP, you contribute up to 25% of eligible payroll funds to the plan, which then uses these tax-deductible contributions to buy company stock — either from existing shareholders or directly from the business. It's a simpler option than a leveraged ESOP, but one that won't provide substantial amounts of immediate cash to shareholders or the company.

Beware the risks

For construction companies, however, ESOPs may not be as attractive as they appear. For one thing, you must record the money you borrow for the ESOP as a liability and debit a like amount to a contra equity account. The resulting reduction in your business net worth may not be operationally significant, but it could affect your bonding capacity.

In addition, employees who leave the company may require you to buy back their shares — creating an off-balance-sheet liability for you. Also, participants may diversify up to 50% of their accounts out of company stock after age 60, which means you must maintain enough liquidity to accommodate these changes.

Another issue is the very nature of your business. Construction companies often have wide earnings swings from year to year, which creates dramatic fluctuations in stock value. With a number of relatively unsophisticated investors building up a substantial investment in company stock over a period of years, this could breed employee morale or turnover issues. Even large publicly held companies have had well-documented problems when stock values have plummeted suddenly, and the risks for a typical closely held construction company are likely to be greater.

Consult an expert

Ultimately, the one sure thing about ESOPs is that you shouldn't decide whether to implement one without expert advice. These arrangements aren't always — or even usually — a perfect fit for construction businesses, but they're still worth considering.

Lifestyle centers: A growing building niche

There's nothing particularly new about the concept, but so-called "lifestyle centers" are riding a wave of popularity with consumers and developers. And this trend could translate into a lucrative opportunity for contractors ready to play a role in these upscale, attention-grabbing projects.

Win over the well-to-do

Essentially, lifestyle centers are open-air shopping centers designed to attract well-to-do customers. Brand-name retailers (J. Crew, Banana Republic, Williams-Sonoma) share attractively landscaped, relaxed "streets" with high-profile restaurants (P.F. Chang's, The Cheesecake Factory, Chipotle Grill) in developments with names like "The Shops of Saddle Creek" or "Towne Center at Cedar Lodge."

The International Council of Shopping Centers (ICSC) notes that lifestyle centers are the fastest growing type of retail construction in the industry. Because they require less space, generate higher sales and have lower common-area maintenance fees than traditional indoor malls, retailers have embraced the concept.

The market for these projects is booming. There were 30 such developments in the country during 2002, according to the ICSC. By the end of 2004, that number had soared to 120 — with another 40 potentially in place by 2006.

Look beyond the mall

Some developers are even adding residential components to their centers, either incorporated into the lifestyle center itself or strategically placed in immediately adjacent areas. And even when residential construction isn't part of a lifestyle center, homebuilding may still be profitable in nearby neighborhoods.

In urban areas, for example, housing developments within a block or two of a lifestyle center may appeal to people who want to work, sleep and play conveniently. In smaller communities, lifestyle centers could offer easier access to higher end retailers than are available in enclosed malls. And, again, nearby residential developments will appeal to those who want only a walk or short drive to shopping, restaurants and recreation.

Thus, even if you don't wish (or aren't able) to bid on a lifestyle center development project, you can look into job opportunities in the surrounding vicinity.

Consider the costs

One area of contention regarding lifestyle developments is whether construction costs for these projects are higher than those for enclosed malls. Some observers say yes, because of the typically higher end architectural details involved. Others say no, because square footage is usually lower.

When considering a lifestyle center project, it's important to perform an in-depth cost analysis to determine which side of this debate you fall on and how that might affect your suitability for the job.

For instance, if construction costs are indeed higher because of a particularly detailed architectural plan, that could mean a substantial profit opportunity for you. But it could also mean a prohibitively complex project, a longer schedule and a greater number of owner conflicts.

Get it while you can

Lifestyle centers are popping up both in major metropolitan areas and in smaller, regional sectors. This may be good news for your construction company, but the prospect won't likely last.

If you wish to profit from the lifestyle center movement, get it while you can. Just be sure to research your local market carefully and assess the potential financial dangers before you jump in.

Futurescope: Construction Business Trends

Improve job-site communication with a smart phone

Cell phones and two-way radios enable you to stay in constant communication with job sites, offices and owners. But you may still rely on cable-based phone connections to complete computerized tasks such as estimating and scheduling.

That creates a dilemma: If the only reason to run a telephone or cable line to a job site is to give you access to your spreadsheet application, is it really worth the time and effort to put it there? Maybe, maybe not. But there is an alternative that more and more contractors are starting to understand and appreciate — smart phones.

Looking like either a large cell phone or an oddly shaped PDA, smart phones offer telephone, wireless Internet, e-mail and even photographic capabilities. Leading manufacturers include Motorola, Orange and Blackberry, with more jumping into the market every day. As of this writing, the devices cost around $500, but can be significantly less if bundled with a wireless phone service contract.

Yet smart phones let you do more than just make calls and surf the Web. They enable you to easily access Web-based software critical to design, computer drawing, administration and project management without the tethers of either cables or telephone lines. That means you and your managers can return e-mails, work on estimates and review proposals when- and wherever it's convenient to do so.

These tools can markedly boost the timeliness of your projects once they're underway, too. Smart phones give field managers the ability to solve problems as soon as they arise — instantly getting to protected company and project data, and immediately completing the necessary "paperwork" without running back and forth to the office.

Contractors have been notoriously cautious (some would say "slow") to adopt new technology. Understanding the value of smart phones — and putting them to work right now — can give you a competitive advantage. After all, those who are slow to move forward may find themselves racing to catch up.

The Contractor's Corner

The latest on "additional insured" coverage

I run a fairly successful general contracting business. It's always been standard practice for me to take out "additional insured" coverage on the subcontractors working on my projects. But I recently spoke with a fellow general contractor who had just suffered a considerable loss when her additional insured policy didn't cover her in a situation she thought it would. Is there something going on with this coverage that I should know about?

Seeking additional protection against insurance claims, owners routinely ask to be named as "additional insureds" on general contractors' and subcontractors' liability coverage. For the same reason, general contractors like you regularly seek additional insured status from subcontractors.

But incidents like the one you refer to are becoming increasingly common. In fact, many industry insiders are beginning to wonder whether the sun is setting on additional insured coverage.

Insurers narrowing provisions

Additional insured coverage gives owners and contractors both a defense and indemnity when insurance claims arise. Claims made against an additional insured are covered by the policy just as if that party had bought the coverage itself — sometimes. Recent changes may limit coverage to only the time period of construction and eliminate coverage after completion.

Increasingly, insurers are narrowing the provisions of their additional insured coverage, and some courts are finding it less comprehensive than owners and contractors anticipate. For instance, many providers are excluding most construction defect claims arising after completion and covering only claims that arise during a project.

Some courts limiting coverage

Even when coverage appears to be in place, courts may deem it invalid. It's even possible that some states could quash additional insured coverage altogether.

If that happens, owners, general contractors and subcontractors would have to sue to determine responsibility, rather than deferring to additional insured endorsements. Many state statutes restrict contracts to not allowing indemnity for one's own negligence and won't enforce insurance provisions to the contrary.

Assuming they're successful, such lawsuits could ultimately cover the parties as insurance previously did. But pursuing this course will no doubt be more expensive and time-consuming. And it may increase animosity between the parties involved because, let's face it, no one likes to be sued.

Standards being set

If additional insured coverage endures, future claims may have to adhere to a specific, fact-based standard rather than the more general standard you've grown accustomed to.

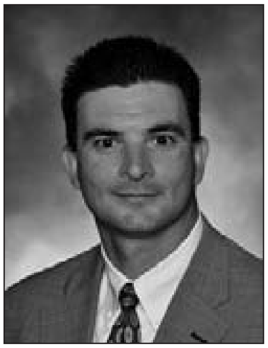
To determine exactly how this shift in the insurance landscape might affect your construction company, consult an attorney for help researching your state's legal history in this area. In particular, try to learn where courts are setting the limits and how endorsements should be worded.

Looking before you leap

When it comes to additional insured coverage, look before you leap. And that means reading any contract terms extra carefully and obtaining an attorney's opinion.

Meet James M. Schreiber, CPA

During his six-plus years with Elliott Davis, Jim has provided comprehensive assurance and advisory services and management consulting services to a broad range of clients including construction companies, non-profit entities, school districts and governmental entities.



Within his construction industry client base Jim focuses on audit and tax services, management consulting and special projects.

"I think construction companies should surround themselves with a specialized team of advisors. Not all accountants have the specialized industry knowledge necessary to provide the level of service required to help construction companies make completely informed decisions," Jim notes. "A construction company's team of advisors should be a reflection of their commitment to success."

A graduate of the University of South Carolina with a Masters of Accountancy, Jim is a Certified Public Accountant in South Carolina, a member of the American Institute of Certified Public Accountants, the South Carolina Association of Certified Public Accountants and the Institute of Management Accountants. Jim can be contacted by phone at (803) 256-0002, or by email at jschreiber@elliottdavis.com.

Construction CPAs – Trusted Business Advisors

CPAs perform a critical service in a company's financial compliance process. Typical services include the audit or review of the annual financial statements and the preparation of the annual business income tax returns. However, companies in the construction industry often need other complimentary services that play a vital role in helping managers and business owners in their decision-making processes. The following paragraphs summarize several of the most sought-after services provided by CPAs specializing in the construction industry.

Surety Specialist

Increasing surety rates and reduced coverage amounts impact most contractors. Your CPA can assist in the negotiation process by addressing concerns related to financial performance and recommend changes that can positively impact net worth and bonding ratios. Also, bonding ratios may be analyzed to determine if long-term debt and leasing structures for equipment and other asset acquisitions are positioned to positively affect working capital.

Most contractors are affected by seasonal ebb and flow of the construction work environment. Changing a company's fiscal year-end or producing interim financial statements to coincide with seasonal activity may significantly improve the presentation of the company's financial position and net worth.

Tax Planning

CPAs provide valuable tax planning services at all stages of a construction company's life cycle. At the company's inception, your CPA may make recommendations suggesting a specific entity type and structure. As the business matures, your CPA is a valuable resource for ongoing guidance relating to income, sales, property taxes, succession planning, and the pros and cons of mergers and acquisitions.

Information Systems Planning and Consulting

First-class operating procedures are powered by superior information systems. Your CPA can make informed recommendations regarding internal controls processes, operating procedures, billing and bill payment procedures, a well as cash management procedures. Also look to your CPA to provide valuable input about the pros and cons of current software products on the market and industry-specific consulting services regarding accounting software. In fact, many accounting firms offer a broad range of information technology services that develop, implement, and support a complete information system network.

Cash Management

Due to the nature of construction contracts, cash flow is critical to continued operations. A CPA can assist clients by designing more efficient billing and bill payment cycles. Billing is critical to cash flow, so contractors need to have a formal billing policy. Your construction CPA should be made aware of all bill payment, billing and collections policies in order to provide advice on creating processes that help you better manage cash flow.

Get To Know Elliott Davis

Since 1925, Elliott Davis has been the accounting advisor and auditor that improves the financial management of small and middle market clients by personally appying national-caliber resources to a broad range of business services. Our mission is simple — help every client achieve the highest level of success and peace of mind possible. That philosophy has helped make us one of the largest CPA firms in the Southeast, and among the Top 60 in the nation.

To learn more about Elliott Davis and how we can help you position your company for sustained profitable growth and continuing success, call us at (800) 503-4721 or visit our Web site at www.elliottdavis.com.

Helpful Links on the Web

Today you'll find a broad range of websites all over the Internet offering tools and advice to help you keep your business successful. Here is a sampling of our favorites:

- **www.cagc.org –** Home site of the Carolinas chapter of the Association of General Contractors
- **www.abccarolinas.org –** Associated Builders and Contractors of the Carolinas
- **www.llr.state.sc.us –** South Carolina Dept. of Labor, Licensing & Regulation's home page
- **www.cfma.org –** CFMA's home site: a must for industry professionals
- **www.gadata.org –** Georgia census data served up in easy, intuitive format
- **www.google.com –** Quite possibly the easiest-to-use search engine for virtually any topic
- **www.developmentalliance.com –** Site selection portal with information on communities across the country
- **www.elliottdavis.com –** Elliott Davis home page

Firm Services

Our service mix is constantly expanding to meet the changing demands of a diverse client base. In addition to highly specialized services for the Construction industry, our broader services include:

- Accounting & Auditing
- Asset & Business Valuation
- Strategic Advisory Services
- Employee Benefits
- Information Technology
- Litigation Support
- Employee Benefits Consulting
- Tax Planning and Preparation
- Wealth Management Services

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AUGUSTA	(706) 722-9090	Bill Woodward
COLUMBIA	(803) 256-0002	Jim Hazel or Todd Soderlund
GREENWOOD	(864) 229-4951	Mickey Young

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