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SPRING 2006

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ElliottDavis

Accountants and Business Advisors

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Skilled labor — who you gonna call?

The shortage of skilled labor that has plagued the construction industry in recent years is likely to get worse before it gets better. That's because, like all Americans, the construction workforce is getting old. According to the federal Bureau of Labor Statistics, the average construction worker is age 47. While your workers may not be researching their long-term care options just yet, they are likely thinking about retiring.

The good news is that unions, construction trade organizations and school districts around the country are working to encourage young people to enter the profession. The bad news is that these programs take time and may not produce skilled workers in the numbers the industry needs today.

Start with a plan

What are the options, then, if you're among the contractors faced with a dwindling supply of skilled labor? There are several.

One is to plan your construction to take advantage of the labor that *is* available. If you try to start a project late in the season, you may be able to attract workers by offering longer workweeks (with accompanying overtime pay).

A better approach is to schedule as many of your jobs as early as possible. Then you'll be able to offer steady work to the skilled people you need. Even the most meticulous scheduling won't get you enough workers if the skilled labor is simply not available, though. Contractors are increasingly turning to immigrants and women to fill positions. To do that, you must understand how to attract these workers — and make your company a place where they want to stay.

Avoid culture clash

With immigrant workers, you need to understand that cultural differences can quickly derail a successful working relationship. Americans often are goal-oriented, punctual and individualistic. In some South and Central American countries, however, it's considered rude to be on time. Some cultures don't believe in setting goals the way Americans do and don't define themselves by their jobs.

Contractors are increasingly turning to immigrants and women to fill positions.

Regardless of any language barriers, communication can be difficult if you don't understand that many cultures don't ascribe to the direct, "get-to-the-point" approach Americans value. In Asia, for instance, it may be impolite or disrespectful to maintain eye contact too long or to smile too much.

When you're ready to interview potential immigrant workers, remember not to judge them by whether they shake hands or maintain eye contact. Keep your interview questions standard for all applicants, and recognize that you may need to ask for written answers if you want to know about past achievements. Not all cultures value individual accomplishments as Americans do.

Women are an emerging force

If you can hire American women, you won't have the cultural conflicts attendant with immigrants, but you will need to ensure they aren't treated as second-class citizens. You may want to add sexual harassment components to your safety and professional development training offerings if you don't have them already.

This will help ensure your female workers receive the same respect their male colleagues receive.

Both women and immigrants may have the benefit of having completed certification programs through their local colleges or unions, but recent graduates of such programs will require some experience to become skilled enough to replace seasoned workers who are ready to retire. Make sure your on-the-job training accommodates different styles of learning.

Raid the competition

If you need skilled, experienced workers in a hurry, consider recruiting competitors' employees. Be careful, though. More and more construction firms are requiring their employees to sign noncompete or confidentiality agreements to make sure they don't take company processes to the competition.

While there may be ways around such agreements, it's important to find out in advance whether a potential recruit has signed one. Terms and enforcement vary from state to state, but employees bound by noncompete clauses are typically prohibited from working for rivals or discussing confidential information for two years.

Although enforcement of such agreements varies from state to state, and there are often ways to work around them, you'll need to determine whether hiring such a worker is worth the potential risk of crossing legal antitrust or patent lines that noncompete agreements are designed to help protect.

Ease the pain

There is no question that a shortage of skilled labor will remain troublesome for contractors for the foreseeable future. Even so, if you do a little planning and work to accommodate immigrant and female workers, you can get through the rough spots more easily.

Cash: The lifeblood of your business

How to keep it flowing

All businesses fight cash flow problems, but it's particularly challenging for contractors. In fact, the Construction Financial Management Association notes that more contractors go out of business because of a lack of cash than because of a lack of profit. It's actually possible to show a profit and still not have enough cash on hand to support your business — even profitable construction firms can feel a pinch when seasonal work slowdowns reduce cash flow to a trickle.

Cash flow culprits

Contractors face myriad reasons — besides unprofitable contracts — for their cash flow problems, including:

- Normal time lag between billing and recording of revenues and collecting receivables,
- Purchasing fixed assets from operating cash,
- Labor-intensive work,
- Paying suppliers or subcontractors before receiving payment from the related project,
- Overinvesting in inventory,
- Inadequate credit (working capital loan), and
- Draining money for outside investments or personal use.

Contractors must work toward both contract profitability and successful cash management if they want to survive.

The cash flow budget

Simply getting more jobs may not be the whole solution, though it's a good start. What's really needed is a realistic cash-flow budget to help you decide how you'll meet annual expenses, whether to take certain jobs and when to schedule expenditures.

To start, consider the jobs you have scheduled for the next year. Figure out your overhead and the expected timing of job-related cash receipts and disbursements on both a job-by-job and companywide basis. This will help you determine what action needs to be taken to meet your obligations. For example, if your business typically slows during the winter months, consider developing a sideline business in building maintenance to help keep your workers busy and cash flowing in.

Improve your cash flow

You can improve your cash capability, increase cash reserves and enhance your company's borrowing power by using these strategies:

Bill smarter. Many contractors overbill, but if you overbill too much you may find yourself in a job borrow situation. Match payment of subcontractors with collections and know what needs to be paid with the overbillings. And, of course, never underbill.

Go for municipal bonds. In some parts of the country, particularly on public contracts, you can get municipal bonds for your retention. The interest income will add to your bottom line.

Watch change orders. Work on getting change orders and claims quickly approved and ready for payment. To compensate yourself for this cost of cash, consider increasing your margins slightly on claims and change orders or any other payment that will be delayed.

Minimize inventory. Keep inventory (warehouse) levels at or close to zero.

Maximize financing. Obtain an adequate line of credit, and obtain long-term financing on new fixed asset additions.

Finally, take the time to review depreciation methods to accelerate deductions and decrease tax liabilities. And get involved with tax planning strategies so you can understand their impact.

Don't ignore the obvious

Ignoring a cash flow problem simply because it doesn't translate into a day-to-day crisis is a mistake. Serious problems may develop over time, which — if identified early — could be properly controlled.

By taking the time to analyze and plan your cash flow situation, you can rest easier, knowing that your business is prepared for whatever the future holds.

Borrowing time?

There are times when you may need to borrow money to stay in business. What if your cash flow analysis shows you'll be out of cash for three months starting next month? What if you're one unexpected problem away from bankruptcy?

Of course, your first steps should be to control spending, add some new jobs and make sure your accounts receivable staff is following up promptly on overdue payments. Borrowing money means you'll pay interest that will increase your cash outflow, and if you can avoid it you should.

But there are times when you have no alternative. If that's the case, your cash flow budgeting processes can help. You can get short-term cash a number of ways, including lines of credit, factoring and asset-based loans.

Knowing what you'll need and for how long can help you decide which is right for you. Each can have an effect on working capital, on loan covenants such as debt-to-equity ratios and on benchmarking ratios.

Qualifying for HCC coverage may become easier

Contractors whose long-term projects are covered by home construction contracts (HCCs) enjoy significant accounting benefits. In many cases, however, it's not easy to determine whether your company or the contract in question qualifies for HCC coverage.

In response to this confusion, the IRS and Treasury Department are reviewing the definition of HCCs via their Industry Issue Resolution Program. They haven't yet set a date for completing the evaluation, but observers expect it to clarify both the meaning of these contracts and the appropriate accounting treatment under them.

The advantages are clear ...

Currently, the IRS defines an HCC as a contract in which 80% or more of the estimated total costs are attributable to:

- Dwelling units in buildings of four or fewer units,
- Real property improvements to such buildings,
- Townhouses or row houses, and
- Common improvements (such as sewers, roads or clubhouses) that benefit such buildings and that the contractor must provide.

When working under an HCC, you need not use the percentage-of-completion accounting method that's required for other types of long-term contracts. HCCs also allow you to avoid costing, look-back requirements and alternative minimum tax (AMT) adjustments, all of which are necessary with nonhome construction contracts.

... but confusion abounds

No one questions that many residential contractors, including roofers and plumbers, qualify for HCC advantages. The confusion arises with construction companies that work on residential jobs but not directly on the houses.

Do concrete contractors who pour streets and sidewalks in a residential subdivision fall under the "common improvements" exception? What about the company that installs water and sewer lines in the subdivision?

Such contractors qualify for the exceptions only if they're working for someone who's building the home, according to the IRS. For instance, a construction company that builds streets for a subdivision developer doesn't fall under an HCC unless the developer is actually building houses in the subdivision.

Property creates problems

In another twist, HCCs don't encompass providing land for a project. But projects where a small construction business (less than $10 million average annual gross receipts for the last three years) builds a custom home on its own property fall under the HCC umbrella, so the company may use the cost comparison method of accounting.

On the other hand, a large (average annual gross receipts of more than $10 million for three years) construction company that builds a custom residence on its own land is subject to spec home rules, under which the house is considered an

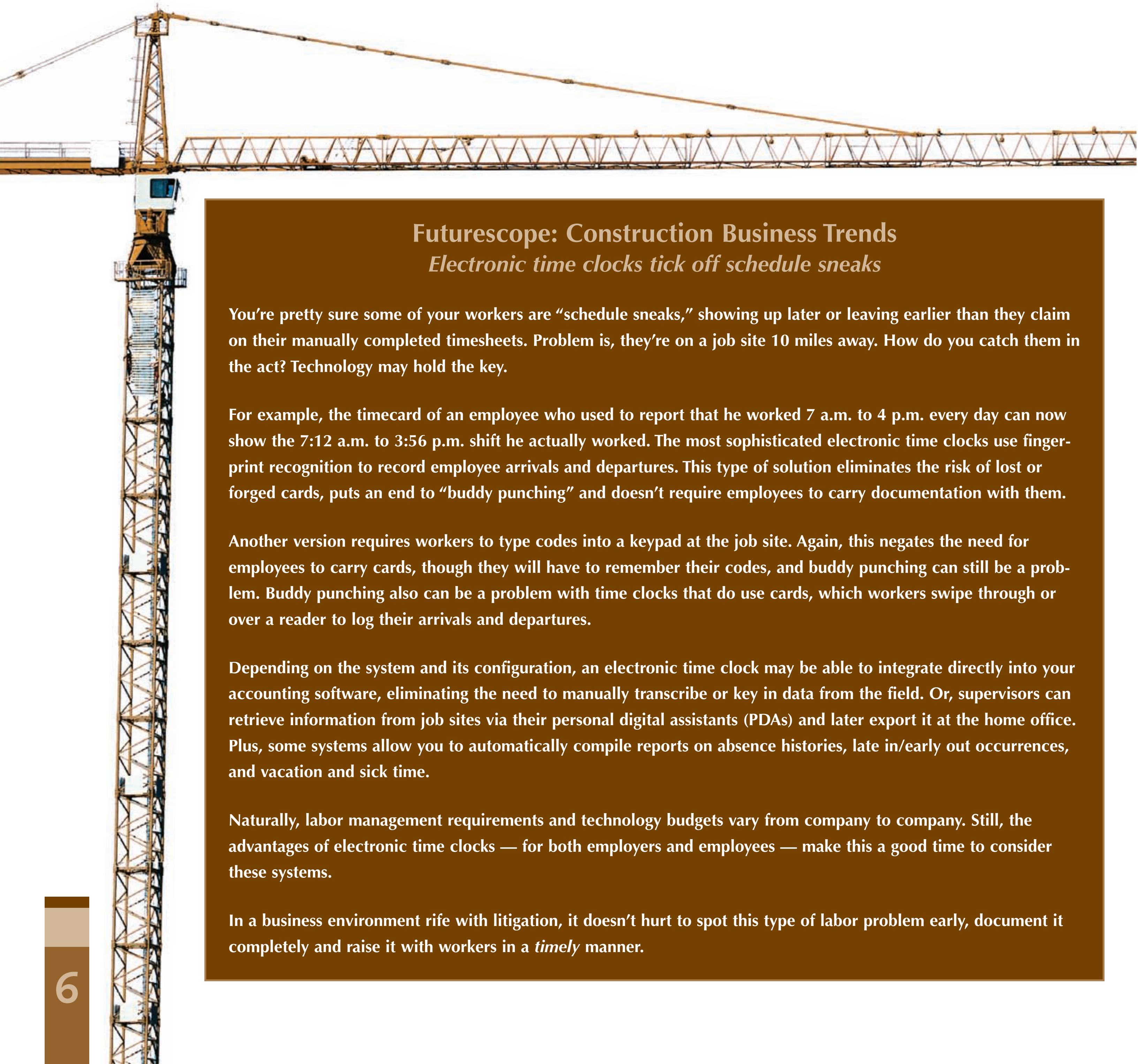
asset for sale and, thus, isn't covered by an HCC. Instead, the business must accrue the costs, and it can't deduct them until the home is sold.

But all contractors, regardless of size, may choose the accrual, cost comparison or percentage-of-completion accounting method for custom homes built on an *owner's* land.

As a result of these and other complexities, many construction companies use one accounting method for long-term projects and another for everything else. Doing so can be time-consuming and expensive.

The effort is welcomed

Associated Builders and Contractors, the trade organization that called for a review of HCCs, welcomes the government's effort. And for good reason — making these contracts more accessible could greatly ease the struggles of contractors everywhere to properly recognize income for tax purposes.



Futurescope: Construction Business Trends

Electronic time clocks tick off schedule sneaks

You're pretty sure some of your workers are "schedule sneaks," showing up later or leaving earlier than they claim on their manually completed timesheets. Problem is, they're on a job site 10 miles away. How do you catch them in the act? Technology may hold the key.

For example, the timecard of an employee who used to report that he worked 7 a.m. to 4 p.m. every day can now show the 7:12 a.m. to 3:56 p.m. shift he actually worked. The most sophisticated electronic time clocks use fingerprint recognition to record employee arrivals and departures. This type of solution eliminates the risk of lost or forged cards, puts an end to "buddy punching" and doesn't require employees to carry documentation with them.

Another version requires workers to type codes into a keypad at the job site. Again, this negates the need for employees to carry cards, though they will have to remember their codes, and buddy punching can still be a problem. Buddy punching also can be a problem with time clocks that do use cards, which workers swipe through or over a reader to log their arrivals and departures.

Depending on the system and its configuration, an electronic time clock may be able to integrate directly into your accounting software, eliminating the need to manually transcribe or key in data from the field. Or, supervisors can retrieve information from job sites via their personal digital assistants (PDAs) and later export it at the home office. Plus, some systems allow you to automatically compile reports on absence histories, late in/early out occurrences, and vacation and sick time.

Naturally, labor management requirements and technology budgets vary from company to company. Still, the advantages of electronic time clocks — for both employers and employees — make this a good time to consider these systems.

In a business environment rife with litigation, it doesn't hurt to spot this type of labor problem early, document it completely and raise it with workers in a *timely* manner.

The Contractor's Corner

Don't let mold grow on your bottom line

I recently heard rumors of a movement among lenders toward requiring us to use new, mold-resistant materials on all of our projects. Is this true? If so, what are the financial implications of such a move?

Severe mold damage can decrease a property's value, and lenders (along with the rest of us) don't like to lose money. Thus, yes, you should look for a growing number of banks to include mold prevention clauses in their loan requirements.

In the short term, this effort will likely drive up materials costs. In the long term, however, it may significantly lessen your risk of protracted, expensive litigation to settle mold-related claims. Taken from this perspective, banks may be doing you a favor by requiring mold-resistant building materials. And you can do yourself another favor by going a step or two further.

Protect yourself

Before accepting a job, negotiate the contract to protect yourself from being held liable for weather damage or the mistakes of other entities, such as the architect/designer or material suppliers. Also, look carefully at the project drawings and specifications to ensure the building is oriented on the lot for proper drainage and that the materials and processes specified are compatible and appropriate for the job.

When construction begins, install high-quality moisture barriers — not just plastic sheeting — under concrete slab or basement floors. Use steel rather than wood framing materials when possible, and keep all wood components in watertight storage on the job site.

Before you put in wood components, inspect them for signs of mold growth. If you can't completely remove the mold, return affected items to the supplier. Finally, test for mold problems at regular intervals throughout construction and again before sale or occupancy.

Head off potential problems

Despite every care you may take, it's a safe bet that water will find its way into virtually any construction project. Decide in advance how you will handle such intrusion, and respond quickly to minimize its effects.

Also determine in advance what responsibilities every member of the construction team will assume. Architects, owner representatives and subcontractors all will be on site at different times, but you can't rely on them to protect you from liability for mold. Instead, clarify the role everyone will play in protecting the project — contractually, if possible.

When the project is finished, you aren't done until you've provided and discussed plans for water intrusion and mold remediation during operation of the building. In addition to meeting many insurers' requirements for coverage of any mold-related cleanup or repairs, such plans can limit your liability in future claims.

Don't let fungi ruin your bottom line

The cost of foiling fungi will undoubtedly look a lot better on your financial statements than that of defending yourself against a mold-related claim in court. Lenders are recognizing this simple truth — and so should you.

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Meet David Turner

David is a senior accountant with the Elliott Davis Construction Group who provides comprehensive assurance and advisory services and management consulting services to a broad range of clients, including construction companies, governmental and not-for-profit entities. With more than six years experience serving a construction industry client base, David focuses on financial complications and special projects.

"In a rapidly changing environment such as the construction industry, it is imperative that we advise clients on how changes impact their businesses so they can respond appropriately," David notes. "But it is just as important that we help them plan and prepare for the future — not just react to what is happening around them."

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How To Please Sureties And Maximize Bonding Capacity

The uncertainties of the construction industry can create a roller coaster ride for all the parties involved. In response, surety companies offer bonds (or "pledge guarantees") to ensure that contractors will complete projects as well as compensate first-tier subcontractors, workers and suppliers. Generally, surety bonds cost less than certificates of deposit or letters of credit.

A surety evaluates a construction company's financial status to determine whether it can qualify for bonding. And, as you may well know, failing to qualify for surety bonds severely limits the size and number of jobs a company can accept. Here are some ways to maximize bonding capacity:

Know Surety Bond Basics

Surety bonds are insurance, but they are also similar to bank loans. Bankers lend money or extend credit on the basis of a company's fiscal stability. Similarly, a surety evaluates the financial resources of a company to determine how likely it is to complete a project.

If a company defaults on a job, the surety picks up the tab — so the surety will process a construction company's economic data through an extended qualification procedure before issuing a bond. And unlike conventional insurers that expect some losses, sureties do not intend to incur any losses. Therefore, a surety will scrutinize a company's financial information more carefully than its banking and insurance counterparts.

Once a company qualifies, most sureties offer three types of surety bonds:

Bid bond
This bond assures the owner that the company has submitted the project bid in good faith, and that it intends to undertake projects at specific bid prices.

Performance bond
A performance bond protects the owner from financial loss should the contractor fail to perform in accordance with the contract.

Payment bond
This bond guarantees that the contractor will avoid liens by paying subcontractors and materials suppliers.

Keep Cash Handy

Sureties look carefully at a company's cash and cash equivalents for assurance that projects will be completed. So, increasing a company's available cash improves its bonding capacity. For instance, setting up an interest-bearing money market or checking account can easily demonstrate interest income and positive cash flow.

Sureties also thoroughly investigate a company's accounts receivable. Most use it to calculate payment likelihood and eliminate any amounts deemed uncollectible. Always precisely disclose contract receivables — separating them from completed contracts, contracts in progress and retainage. Also, include unbilled receivables or receivables billed after the balance sheet date.

Manage Debt Wisely

Along with liquidity, debt also significantly affects bonding capacity. Increase working capital (current assets minus current liabilities) by refinancing high-interest, short-term debts to low-interest, long-term ones. And pay bills after fiscal year end. Although paying bills early feels good, doing so negatively affects working capital because sureties discount prepaid expenses.

Restructure credit lines so that maturity dates extend beyond the next operating cycle. Thus, sureties will classify them as noncurrent liabilities. And do not borrow from credit lines to finance equipment. These transactions increase current liabilities and noncurrent assets, immediately reducing working capital. Consider leasing instead. If the goal is to eventually own the leased equipment, establish a separate rental company to buy it.

Form a New Company For Nonbondable Projects

A construction company that performs nonbondable and bondable projects should consider forming a separate company for nonbondable work. By doing so, nonbondable jobs are excluded from those that sureties scrutinize.

Last, beware of the other side of debt. That is, do not loan money to company officers or others. Sureties frown on these loans because many contractors never get their money back. If money has already been loaned to an individual, formally document the arrangement — including repayment specifications and interest rates. Otherwise, a surety will exclude this money from the current assets or insist that the debtor repays the loan before year end. If the debtor cannot comply, modify the loan terms to reflect repayment in the near future.

Certainly, Positively, Absolutely

Before a surety will underwrite a construction project, it must have confidence in a company's character, sound experience and, most importantly, its strong financial position. Although all the smudges on a company's financial records may not be removable, there are many activities that can maximize a construction company's bonding capacity. Need some help? Please call us — we can advise you on how to please sureties and win the best jobs.

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