Mueller Prost
CPAs + Business Advisors

DIMENSIONS

A CPA's Report to the Construction Industry

RECOGNIZE...PRIORITIZE...MITIGATE
Managing Risks During Recovery

The signs of economic recovery are still uneven, with some areas of the country and certain sectors of the construction industry still lagging behind others. Nevertheless, the most recent surveys of construction industry executives indicate growing optimism that a full-fledged recovery could be imminent.

Ironically, this accelerating stage of the business cycle can pose its own risks to contractors. By approaching the recovery from a risk management perspective, it's possible to recognize some of these risks and make plans to avoid or mitigate them.

Major Risk Categories

A good way to start is by identifying the various categories of risk that contractors face as the recovery gains momentum. No such list is all-inclusive, but here are some of the most prominent risks to consider:

- **Financial risks** – As activity resumes on long-dormant projects, contractors should be especially vigilant that project owners have adequate financing. Many owners' balance sheets show the effects of the prolonged downturn, with working capital drawn down significantly. Before committing to new work, always double check the financing.

  At the same time, contractors should also ask themselves some hard questions: Do we have adequate financial resources to take on new jobs? How much work can we commit to before we'll need additional financing to cover short-term costs?

  Sureties also become more vigilant as their risk exposure increases. Be sure to keep the lines of communication open to maintain adequate bonding capacity.

- **Strategic risks** – Reassess your bidding processes, including the types of projects you pursue. Will you be unable to take on more lucrative work because you are tying up resources on low-margin projects?

  On the other hand, you don't want to risk missing out on opportunities because high margins make you noncompetitive. The challenge is to maintain the right balance.

- **Operational risks** – The downsizing of recent years inevitably led some skilled workers to move to other areas or other types of employment. As a result, many contractors are finding it difficult to rebuild their lean crews to take on new work.

  Another critical component of operational risk is safety. Pay special attention to safety training for both new crews and experienced hands. (See "Safety Training — A Key Risk Management Tool" on page 3 for more details.) Many economists also warn of likely increases in material costs — this adds another element of risk to job costing and bidding.

- **Supply chain risks** – An upsurge in business can put added stress on unprepared suppliers or subcontractors. Their failures could leave you vulnerable to extra costs and delays.

  If you haven't done so already, implement subcontractor prequalification criteria, and establish or review sub-bonding requirements as appropriate. It's also wise to contact banks, bonding companies and other industry sources for information on specific suppliers or subcontractors if you have concerns.

- **Regulatory risks** – Considerable uncertainty surrounds the coming launch of the Patient Protection and Affordable Care Act, as

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implementation schedules for some of its most sweeping provisions continue to shift. This lack of clarity makes it difficult for contractors to accurately estimate labor costs on long-term or medium-term projects.

Compliance with other regulatory requirements — from employment and hiring practices to pension and retirement funding — is also subject to increased scrutiny as the pace of work picks up.

Assessing and Prioritizing Risks

The list of potential risks could go on at some length, so it's difficult to decide where to start your risk management efforts. One way to get a handle on the issue is to map out the entire life cycle of a typical project — from the first bid through final collection. Then work with your best managers to identify all the various types of risk that can occur at every stage.

Next, assess these risks in terms of both their likelihood and their potential impact on your company. Those risks with both high likelihood and a high potential impact on your company's ability to survive should be addressed first.

By identifying, assessing and prioritizing risks, you will be better prepared to position your company to take advantage of the coming "up" phase of the business cycle.

If you would like to discuss risk management, please call your Mueller Prost advisor at 314.862.2070.

HELP EMPLOYEES THINK LIKE OWNERS

Deferred Compensation and Phantom Stock Plans

Bonuses, commissions and other cash rewards can be useful for incentivizing a specific action or behavior; for example, cutting costs by a targeted amount, or achieving some other quantifiable goal such as reducing time lost due to accidents.

But how do you reward employees for demonstrating long-term loyalty over the years and making consistently solid, sound decisions? Even more important, how can you encourage employees to start thinking like owners — to take actions based on the long-term interests of the company, rather than their own specific concerns?

For large contracting companies, a formal employee ownership plan such as an ESOP, 401(k) plan or stock options could provide a way. But such programs can be expensive and complicated, and they're subject to complex regulatory requirements that limit management's flexibility.

For smaller contractors, offering key employees an actual ownership stake in the business is one alternative, but most owners are hesitant to make this move, even if the employee is an outstanding performer. One obvious concern is what to do if the relationship takes a turn for the worse and the owner finds it necessary to discipline or discharge the employee.

In addition, many contracting companies are family businesses, so owners are understandably reluctant to dilute their ownership. What's more, such companies are commonly structured as pass-through entities — either S corporations or limited liability companies — so offering actual ownership shares could greatly complicate everyone's tax situation. There may also be legal limits on the number of owners.

Phantom Stock Plans

Phantom stock plans, also called shadow or unit stock plans, are one attractive alternative. Phantom stock is not actual stock — it is a form of deferred compensation that is indexed to the value of the company.

For publicly traded companies, the typical phantom stock plan establishes compensation units that derive

Deferred Compensation and Phantom Stock Plans, cont.

their base value from the value of the company's common stock. As the stock's value increases over time, the value of the employee's phantom stock units increases by an equivalent amount. Typically, the unit value also adjusts to reflect stock splits, dividends or other changes.

For privately held companies, the base value may be established through a stated valuation formula or an objective third-party valuation, which is then updated regularly and reported to the plan participants.

One variation of phantom stock is stock appreciation rights (or SARs). These provide the employee the right to the monetary equivalent of the increase in the value of a specified number of shares over a specified period of time.

Pros and Cons

Like other forms of deferred compensation, phantom stock plans can be helpful in retaining key employees. This is because the actual payout is contingent upon their remaining with the company for a period of years or until retirement. Employees are also typically required to sign broad noncompete agreements.

After retirement or the completion of a number of years of service, the phantom stock value is paid to the employee in installments over a period of years. This deferred payout offers several advantages.

For the employer, deferred compensation allows the company to retain working capital on the balance sheet. This can be important for bonding and credit purposes.

For the employee, there are definite tax advantages. The employee reports no income and the employer takes no deduction until the phantom stock installments are actually paid at some future date.

One potential downside to the employer (especially in a closely held company) is the need to share certain confidential information with the phantom stock recipients as part of the valuation process. For employees, a potential disadvantage is that the promised payout is just that: a promise, not a guarantee. If the company encounters difficulty, holders of phantom stock may have to compete with other creditors for payment.

Setting up a phantom stock plan can be complicated. Because they are so flexible, many decisions must be made regarding who can participate, vesting rules, how to value the company, and how to account for gains or losses. There are also important tax and regulatory questions to consider, so be sure to consult with your legal and accounting professionals for assistance.

To discuss phantom stock and other deferred compensation plans in more detail, please give your Mueller Prost advisor a call at 314.862.2070.

PROTECTING YOUR MOST VALUABLE ASSET:
Safety Training - A Key Risk Management Tool

The most important benefit of an effective safety program is the protection it provides to your employees, who are the most important asset of every successful contracting business. In addition, an effective safety program can also help your company control costs — and thus be more competitive — and manage various other types of related risks and expenses.

Consider the various costs, both obvious and hidden, that can stem from a jobsite accident:

- The direct cost of medical care and indemnity payments to the injured employee.
- Potential legal fees involved in handling any claims.
- Lost production time and schedule delays, which could trigger contract penalties.
- Possible fines from the Occupational Health and Safety Administration (OSHA) or other agencies.
- Higher premiums for workers' compensation insurance.

Other costs may not be traceable to a single event, but are still significant. For example, absenteeism and turnover are higher among employees who do not feel their employer is genuinely concerned for their health and livelihood.

In addition, accidents can also damage your company's reputation in the industry, which could affect your ability to compete for other projects. Project owners often inquire about contractors' and subcontractors' safety records, including lost-time accidents, experience modifiers and their history of workers' compensation claims.

Achieving a "zero accidents" operation requires effort and leadership, starting at the top. If a company's senior management demonstrates that safety is a core value, frontline supervisors and field personnel will adopt the same attitude. Ultimately, the job superintendents and employees are the ones who make the program succeed.

A regular training schedule helps further instill this culture of safety — provided the training is relevant to the work being performed. An effective program will cover a range of topics, including:

- **Recognizing hazards**
  Every employee should understand the inherent dangers involved in working at heights, trenching, entering confined spaces, and using machinery or hazardous materials.

- **Best practices**
  There is a safe — and an unsafe — way to perform virtually every task. Even a relatively simple position like highway flag operator requires training. In fact, this is a prime example of a job that requires lower-level skills but carries very high risks and stakes.

- **Accident response**
  If there is an accident or emergency, all personnel, from the office to the field, should understand the appropriate actions to take.

- **Safety equipment and protective gear**
  Workers should be fully trained in the proper use of fall-protection harnesses, communication devices, personal protective gear, lockout/tagout systems and other relevant safety equipment.

- **Hazardous materials and labeling**
  Many serious accidents can be avoided if employees learn the basic rules about labeling chemicals and other materials.

Safety Training Begins with You

Contractors should begin safety training before any new employee sets foot on the jobsite, and then continually update and document every component, including daily "tailgate" or "toolbox" sessions.

Numerous programs and training materials are readily available from OSHA, trade associations, equipment manufacturers and private vendors. All the programs have the same goal: to make working safely the default mode on every project.

If you would like to discuss safety programs in more detail, please call your Mueller Prost advisor at 314.862.2070.

New Lease Accounting Rules and Financial Statements

After considerable controversy, the long-anticipated revisions to lease accounting rules are about to be finalized. These could have potentially significant effects on many contractors' financial statements.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published their latest revisions to the proposed leasing standard in May, and public comment on the changes continued through September 13.

Under current accounting rules, most leases do not appear on a company's balance sheet. For example, if you enter a five-year lease on a piece of equipment with a 10-year useful life span, the monthly lease payments appear on your income and expense statements, but there is no balance sheet entry reflecting the value of the lease. The same principle applies to operating leases involving office or warehouse space.

Under the new standard, such a lease would be considered a "right-of-use" asset. You would be required to book the value of your right to use the property or equipment as an asset and record the present value of the scheduled lease payments as a liability. This could cause many contractors to be out of compliance with loan covenants or surety requirements that use the debt-to-equity ratio as a key metric.

There are also concerns about how interest, expenses and cash flows related to leases are recorded on the P&L. In order to minimize the negative effects, the amortization methods for real estate leases will be different from those used for leases of equipment or vehicles.

If all goes as planned, the new standard should be finalized in early 2014. While implementation is still several years away, it's not too soon to begin thinking about the transition — and to communicate with lenders and sureties about how this standard could affect your financial statements.

Call us today at 314.862.2070 to discuss how you can prepare for these coming changes.

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