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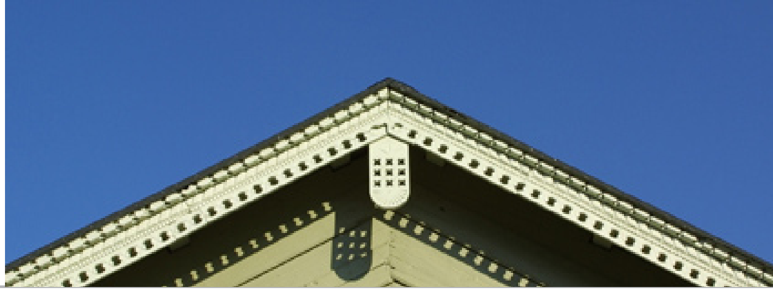

DIMENSIONS

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Understand Your Contracts: Right Cost Language Can Mean More Profitable Jobs

Project owners today are more concerned about reducing construction costs than at any time in the recent past. While most contractors would naturally prefer a negotiated, fixed-price contract, more owners are now requiring cost-plus contracts, often with a guaranteed maximum.

At the same time, contractors are sometimes reducing the fees they collect on such contracts to unrealistic levels simply to win the work. This is especially true on larger projects, where fees are often trimmed below 2 percent, even though most contractors typically need at least 6 percent to break even.

With profits under such pressure, achieving a favorable outcome often depends on the terms in the contract, particularly the way job costs are defined. For contractors who are accustomed to dealing with fixed-price or lump sum contracts, this can require a change in mindset. Many costs that would be absorbed as a regular cost of doing business under a fixed-price contract can legitimately be charged to the specific job on a cost-plus project.

Contract Tips to Consider

Here are some contract pointers that can help you earn a better-than-break-even margin while still offering a competitive fee:

Be clear on the contingency fund. Often an area of dispute, the contract language should clearly state that the fund is established and managed by the contractor to control the financial risks associated with performing the work. Such risks include variances between the budget and actual bids, labor or material cost increases, minor weather delays, and other non-scope changes. The contract should make it clear that disbursements from the contingency are at the discretion of the contractor.

Include a labor rate exhibit. Spell out specific labor rates for supervisory, administrative and trade labor along with additional markup to cover overhead. By incorporating specific labor rates into the contract, you safeguard your ability to charge rates greater than actual cost while limiting the owner's recourse under the contract's "right to audit" clause.

Include support staff in the labor rate exhibit. Some classifications that are often overlooked include accounting staff in your principal office, estimators and safety personnel.

Include additional markup for tools. This labor markup covers the cost of small tools used on the project. Rates up to 4.5 percent of trade labor cost for small tools are not unusual.

Include markup on trade labor. When performing construction work with your own labor, be sure the contract contains markup on the trade labor to cover your overhead. Overhead rates on self-performed work typically are between 6 percent and 10 percent of trade labor costs.

Include charges for contractor-owned equipment. This can be a valuable profit center. Establish a list of all equipment your company owns, along with daily, weekly and monthly rates that are equal to published rates such as those in the *Associated Equipment Dealer's Green Book*. For equipment not listed, use comparable local rental rates. On fixed price contracts, many contractors routinely fail to charge owners for the cost of equipment needed to execute change orders.

Include data-processing costs. Evaluate whether it makes sense to charge an hourly rate for supervisory and administrative time billed to the job, or to establish a monthly rental rate for each computer used on the project.

Understand Your Contracts: Right Cost Language Can Mean More Profitable Jobs, Cont'd.

Include safety-related costs. The contract should state that all costs necessary to implement the contractor's safety program are to be included in the cost of the project. This includes offsite training, the general safety director and other related costs.

Consider restructuring how the fee is determined. Rather than basing the fee solely on a percentage of project costs, consider charging a fixed fee based on the guaranteed maximum price. Lock in the fee in the event the project scope is reduced or the owner terminates the project for convenience. Contract language should state that the fee will be increased for change orders adding to the project scope, but not decreased for change orders that reduce scope.

Clearly state the guaranteed maximum price. Regardless of how the fee is determined, the contract should contain language stating the price, and specify that it does not apply to individual budget line items in the schedule of values.

Clearly define markups on change orders. Establishing predetermined fees for each tier of contractor and subcontractor reduces the potential for dispute during construction. For example, you might charge a 10 percent markup for overhead, a 5 percent fee for the contractor performing the work, and a fee of 5 percent for the overseeing contractor.

Attorneys often say, "The side that knows the contract best wins." A well written contract, properly understood, will allow you to earn a better-than-break-even margin while still offering a competitive fee.

Call us at 314.862.2070 to discuss earning a fair return.

TIME FOR NEW OWNERSHIP?
Start Planning Today for a Smooth Transition

This is the first in a series of articles on successfully transferring ownership of your contracting business.

It has been said that the best time to start planning your exit strategy is the day you open for business. For contractors, it's always prudent to be thinking about how you can capture the value you have built up in your company, and what will happen to your business when you decide to move on.

Begin by asking yourself why you might leave. Are you ready to retire and need continuing income to maintain your lifestyle? Are you pursuing a new opportunity and need immediate cash to finance it? Or are you simply trying to ensure a secure future for your family and employees?

The answers to these questions will help you choose from among the four primary options that are available for exiting your business.

Option #1: Sell to a third party. Selling to an outsider is usually the best way to maximize value. Unfortunately, it can also be the most difficult option if there is a lack of interested and qualified buyers.

The most likely outside purchaser is another contractor looking to expand into your market, or a competitor trying to build market share. If this is your preferred exit strategy, take steps to maximize the value your business offers the potential buyer over and above the liquidation value of the assets.

For example, build long-term relationships or ongoing revenue streams (such as service contracts) that can be transferred with the business. One of the biggest potential sources of added value is an experienced, stable team of talented managers and supervisors who will stay with the business under new ownership.

An outside buyer might expect you to remain active in the business during a transition period, which can range from several months to several years. Your payout could also be spread out over time, and don't be surprised if the buyer wants to include some sort of earn-out provision.

Option #2: Transfer ownership to family members. Transferring ownership to family members - either through a sale, gift or some combination - is one of the most common ways for a contractor to exit the business. In fact, this is often the plan from day one.

The biggest challenge is usually financing. An owner's children may not have enough money for an outright purchase, and lenders can be reluctant to finance a large portion of the purchase because increased debt can strangle cash flow and restrict the company's borrowing and bonding capacity.

Once again, a long-term payout is likely. A typical arrangement is a five- or seven-year note with fixed payments of principal and interest to cover the liquidation value of the physical assets, coupled with earn-out payments based on the company's performance.

Selling or giving the business to family can also raise emotional and relationship issues, especially if not all family members are equally interested in or capable of managing the business. Turn to a trusted outside adviser to provide objectivity in terms of valuation and transition practices.

Option #3: Sell to key employees. While this can present the same financing challenges as selling to your family, the emotional and intangible considerations can be less complicated. Just like family members, though, key employees are unlikely to have enough cash to purchase the company outright, so any payout will probably occur over time. An employee stock ownership plan (or ESOP) can offer another option, but an ESOP is quite complicated and has significant tax consequences. If you want to explore an ESOP, plan to spend considerable time with your accountant, lawyer and other professional advisors.

Option #4: Liquidate the assets and close the business. This is generally a last resort, since it provides the least return on your investment, leaves your employees without jobs, and leaves your family without an ongoing business to build upon. The goal of exit planning is to avoid this alternative - which is why it is so important to start planning early, while other options may still be available to you.

In our next issue, we will look at valuation and determining your company's true worth.

It's never too early to start planning for a successful business transition. Call us today to get started.

VARIABLE INTEREST ENTITY (VIE) REPORTING:
Clearing up the Confusion on Consolidation

In the wake of the Enron scandal, the Financial Accounting Standards Board (FASB) developed new reporting standards that apply to variable interest entities (or VIEs). The rules were designed to provide more transparency to creditors, and to bring off-balance-sheet activity back onto corporate balance sheets.

Because of the complexity of the rules, many companies struggled to implement them. In an effort to clarify the rules, the reporting standards were revised in 2009. Although it has now been more than two years since the update, these changes are still generating some confusion.

Why It Matters to Contractors

How do these changes affect the construction industry? Some contractors use a VIE to form a separate entity that owns their company headquarters, warehouse or other real estate, or to purchase equipment and lease it back to the parent. A general contractor may also use a VIE to hold a controlling interest in a specialty subcontractor, while protecting the GC's assets from potential liability or losses.

In June 2009, the FASB issued Statement 167 (which is now incorporated into *FASB Accounting Standards Codification Topic 810-10*), updating the financial reporting guidelines that apply to such entities. Among the many changes in FASB 167, three are particularly note worthy for contractors (see chart below).

The standard specifically requires enhanced disclosure whenever the VIE's creditors do not have recourse to the general credit of the primary beneficiary. When a bank lends money to a contractor-owned VIE, the loan agreement will almost certainly give the bank recourse against the contractor's assets. This has led many companies to believe this enhanced disclosure of assets and liabilities is not needed for their VIE.

The problem, however, is that the term "creditors" can include other businesses that may not have such recourse. This may include other subcontractors, suppliers who sell on credit, or even a project owner who relies on a contractor's consolidated financial statements to make credit-related decisions.

FASB committee members report many companies are still wrestling with whether they must present this enhanced disclosure. Because financial statements may be read by many other potential creditors, enhanced disclosure is the more prudent course, even if it makes the balance sheet more cumbersome.

Changing financial reporting rules can make compliance a challenge. Count on us for clear and up-to-date guidance.

Issue	Old Rules	FASB 167 Changes
Analysis	Businesses were required to perform a quantitative analysis of risk and reward to determine whether a VIE's assets and liabilities should be consolidated onto the parent company's balance sheet.	Businesses must perform a qualitative analysis that also considers other, non-financial factors.
Beneficiary Determination	Determining whether an enterprise is the primary beneficiary of a VIE was done at the time the VIE was formed. Unless there was a major restructuring or other event, that determination would stand indefinitely.	Companies must reconsider this question ever year.
Disclosure	When the assets and liabilities of a VIE and its primary beneficiary were consolidated, only the consolidated totals were shown on the financial statement.	Companies may be required to break out certain assets and liabilities for VIEs. The result can be a considerably more complicated finan-cial statement, with multiple entries that often appear to duplicate information elsewhere on the statement.

Background Checks: What, When, How and Who

There are limits - both practical and legal - to the steps you can take in conducting background checks on prospective employees. Beyond fundamentals, such as basic identity information and criminal history, what else should you check to protect your company?

Many positions merit more extensive screening - reviewing driving records when hiring a truck driver, for example. On the other hand, it would be difficult to justify reviewing driving records when you are hiring a receptionist or other employee whose job does not require driving. Consider the specific qualifications for the job being filled, and adjust your background check procedures to meet those criteria. For example:

- Confirm proper licensing and other qualifications for skilled trades.
- Verify work history (and for many positions, credit history as well) to alert you of potential concerns.
- Conduct preemployment drug screenings, as required.

Knowing *what* to check is equally important as knowing *when* to check. Even a minimal background check could reveal an applicant's age or other factors that you cannot legally consider when hiring. So performing detailed background checks on all applicants could expose you to allegations of discriminatory hiring practices.

It's better to perform a detailed check only after you have made an offer, which is contingent upon the applicant successfully passing your screening. Be sure you have written permission from the applicant to conduct this check. The same principle applies to verifying the potential employee's legal authorization to work in the country.

Many companies find it worthwhile to periodically update their employees' background checks. Again, be sure you have employees' permission, and be careful to perform these checks as a matter of policy, rather than singling out individual workers.

Finally, remember to always consult with your attorney for specific guidance about hiring and employment practices.