Mueller Prost PC
CPAs + Business Advisors

DIMENSIONS A CPA's Report to the Construction Industry Spring 2013

MAKING IT WORK

How to Take Over a Troubled Project

When a contractor is replaced midway through a project, the opportunity for the new contractor who takes over can be significant, but so is the potential downside.

Is taking over an ongoing job worth it? How can you mitigate the risks and turn a troubled project into a success story? Here are some points to consider.

Tread Carefully

When faced with the opportunity to take over an ongoing project, the first step for the new contractor is to talk to the project owner at length to fully understand the existing situation. What caused the issues? Was the previous contractor in over his or her head? Or was something else at the root of the problem?

The goal at this point is two-fold: First, you need this information to make a wise decision about whether to step in. Second, and just as important, you want to learn how to prevent the same problems from recurring. You will also be laying the foundation for a more successful relationship with the owner if you do decide to take over the project.

Don't stop with the owner, though. If possible, talk to the former contractor to get his or her side of the story. Take the time to read all the prior meeting minutes between the project owner, architects, engineers, project manager and other contractor representatives.

Then talk directly with the architects and engineers to get their feel for the situation. Speak with all the subcontractors as well to determine if they were part of the problem. If they weren't, find out if they want to continue working on the project.

Above all, make sure the project financing is still viable before making any commitment. Verify that the lender would be willing to sign off on a new contract and that the owner has sufficient funding capacity to keep the project going.

Make a Fresh Start

If you do decide to take on the challenge, it's usually smart to plan on completely rebidding the work. Many of the previous contract's provisions could be acceptable, but they do not necessarily reflect the current situation.

Begin with a complete new scope of work that defines what still needs to be done, the current site conditions, the status of materials and similar issues. Then request all new bids from the interested subcontractors, and build in contingencies in case you need to rehire a sub that was part of the problem.

Once the project has been rebid, reconfirm all the financing arrangements directly yourself — this is vital in a troubled contract. Also clarify the exact documentation the lender will require in order to release monthly draws.

Build Some Early Momentum

A change in contractors almost always means time has been lost, so it's important to get work restarted promptly. That could mean operating under a temporary, short term contract just to get things started while the full contract is still being negotiated.

Once work resumes, look for areas that can be worked on concurrently, and review the proposed job sequencing to see if other workers can be brought in to do work that has been delayed.

Communicate Clearly, Manage Flawlessly

Frequent status meetings are a must, with detailed and accurate documentation of all agreements. Go out of your way to add value to the project and demonstrate to the owner that you are committed to its success.

Pay particular attention to change orders. Clarify who has change order authority on both the owner's side

How to Take Over a Troubled Project, Cont'd.

and the contractor's side, and make sure the agreed upon change order process is followed scrupulously. Lack of attention to detail here can quickly destroy any goodwill you have built up.

Be prepared to exercise your very best project management skills. Be ruthlessly efficient about equipment utilization, job sequencing, materials staging and other project management essentials. They're more important than ever when you are managing a project that has had problems.

Finally, bear in mind there could be tax and financial reporting consequences related to revenue recognition and other long term project issues. Ask your Mueller Prost PC accountant or consultant for specific advice.

GUARDING YOUR MARGINS

Protect Yourself Against Rising Material Costs

As the construction industry regains momentum, industry groups and trade publications report scattered examples of rising prices of some critical materials, which could start to impinge on contractors' margins.

For example, the recent uptick in residential construction has already caused prices for gypsum, insulation, lumber and plywood to increase significantly. On the other hand, costs for metals and paving materials are climbing very slowly and, in some cases, sheet metal and asphalt prices are actually slightly lower than a year ago.

Drastic increases in material costs can turn an otherwise profitable project into a money loser.

Volatile prices for diesel and other fuels add even more uncertainty to the picture. In addition to having a direct impact on highway and heavy construction projects, today's dramatically higher fuel costs also drive up prices of other materials, since higher shipping costs must ultimately be passed on to customers.

Drastic increases in material costs can turn an otherwise profitable project into a money loser, especially on longer term projects that are more susceptible to price volatility. While it is impossible to eliminate price fluctuations altogether, here are five common sense steps to help limit your risk.

1. Protect yourself in the contract — if you can.
The most obvious way for a contractor to minimize the risk of escalating material costs is through a cost-plus contract, which shifts all the risk of price increases to the owner. Pure cost-plus contracts are rare, however, and in many cases are undesirable or unacceptable for a variety of other reasons.

Short of an outright cost-plus contract, you may be able to negotiate escalation clauses that help spread the risk of rising costs among contractors, subcontractors and owners. Typically, such clauses specify that if a subcontractor's prices for critical materials escalate beyond an agreed-upon trigger point, the general contractor will agree to pick up a portion of the increase. Such clauses are also rare, however, and do not solve the problem unless the owner also agrees to participate.

2. Put systems in place to document price escalations.
If you do succeed in negotiating an escalation clause, you will need to document and justify your price increases. Be prepared to show that your escalating costs were outside of your control, and not just the result of your failure to buy intelligently. Proper

Protect Yourself Against Rising Material Costs, Cont'd.

documentation is essential if you expect to recover these costs.

3. Stay alert to economic and commodity developments.

In addition to following price projections from construction associations and industry publications, savvy contractors will also talk with their suppliers and manufacturers' representatives about what to expect. You may not get a firm prediction or commitment, but their insights could alert you to possible trouble ahead.

4. Consider buying in advance.

Purchasing materials in advance may expose you to other problems, including cash flow issues, storage costs and the risk of loss or theft. But if you have a firm contract and are confident of your continued need for certain raw materials, it can make sense to purchase some price sensitive commodities in advance.

Ideally, you would make a purchase commitment with your supplier, but arrange for delivery at a later date. Suppliers may be reluctant to enter into such agreements, but it is worth the effort to at least try. If the supplier is willing, this could relieve you of the cost of storage and the risk of loss or damage before the materials are consumed.

5. Get to know your suppliers.

Even when prices are stable, it is important to be dealing with reliable, reputable and informed suppliers. When shortages crop up, as they have so often in recent years, it pays to be working with a supplier who has built up loyalty and has the ability to get you scarce materials when you need them.

With prudent bidding, patient negotiating and careful attention to detail, you can limit your exposure to rising material costs and protect your company from unpleasant surprises. These steps are a good starting point.

For more information on practical risk management strategies, please call us at 314.862.2070

THE "THREE Cs"

How to Address Sureties' Concerns

In the wake of an extended economic slowdown, many contractors are now concerned that their plans for recovery could be limited by their reduced, recession level bonding capacity. How can you address sureties' concerns and make a positive presentation about your company's capabilities?

The place to begin is with a clear understanding of what matters most to the surety underwriter. In general terms, their concerns can be grouped into three broad categories — the "three Cs" of capital, capacity and character.

1 CAPITAL: Is Working Capital Adequate?

Financial performance is the first area of surety concern, beginning with adequate working capital. Maintaining working capital equal to about 10 to 15 percent of annual revenue is a good rule of thumb, but this can vary. What matters even more is your ability to demonstrate that you have a firm grasp on your working capital number at all times.

Note that sureties typically adjust the textbook definition of working capital (current assets minus current liabilities) to reflect certain realities. For example, they typically discount assets such as related party receivables, and generally do not include inventory, prepaid expenses or other assets that cannot be readily converted to cash.

Sureties will also want to see that you have access to sufficient credit to meet short term requirements. In the case of a flow through entity such as an S corporation or LLC, underwriters may ask about any deferred tax liability — they want to be sure you are prepared to meet this liability without restricting your ability to cover ongoing expenses. You should also expect to discuss your accounts receivable in detail to provide assurance that past due receivables will not cause a cash crunch.

2 CAPACITY: Can You Handle the Job?

The next area of concern is capacity — your ability to complete projects on time and on budget. Provide a detailed picture of your project completion record, and be prepared to explain any problems, especially if they led to exposure for a surety company.

Your surety will also want to see whether you are working within or outside your area of expertise. One way to overcome such concerns is to team up with a joint venture partner who has experience in the specific type of project being bonded. A joint venture can also help alleviate capital concerns by spreading risk more broadly, especially on large or complicated projects.

A surety will also spend considerable time reviewing your work-in-process ledger, including job schedules, job performance histories and project updates. Be ready to demonstrate a strong grasp of the projected revenue flow for each job.

Underbillings and profit fade are major red flags for sureties, so your ability to track profit gain and profit fade is another critical concern. Be conservative on job costing until you are certain you can lock in the profit, and be prepared to discuss any underbilling in detail.

Calculating all the various ratios that sureties examine means you must maintain detailed records of all transactions, along with extensive and up-to-date job records.

3 CHARACTER: Are You Stable and Well Managed?

Above all, be honest. Trying to hide problems from the underwriter will seriously undermine your credibility.

But "character" involves more than your personal character alone. It also refers to the general character of your management and the business as a whole.

Surety underwriters obviously prefer to see a history of profitability in varying market conditions. In addition, they are looking for evidence of a stable, well-managed operation that accurately tracks, reports and documents costs. Finally, they want to see a solid management team in place, with adequate succession plans that can address potential changes in key personnel.

By protecting your credit status, keeping complete and accurate records, and completing projects on time and on budget, you are taking the first steps toward building your bonding capacity to the levels you need to grow your business.

Get Ready for New FASB Revenue Recognition Rules

After many years of discussion, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have agreed on a new revenue recognition model. This new model could fundamentally change the way some construction companies recognize and report revenue on long term contracts under U.S. generally accepted accounting principles (GAAP).

For many years, the percentage of completion method has been the most widely used method for recording revenue from long term contracts. Under the new standard, this relatively straightforward approach will, in many instances, be complicated by a new procedure that requires long term contracts to be broken down into a series of separate "performance obligations." If a contract contains multiple performance obligations, contractors would need to allocate the appropriate portion of the contract price, the costs to date and the total anticipated costs to each of the performance obligations.

One of the biggest challenges will be how to break down complex contracts into separate performance obligations. The decision revolves primarily around when the customer gains control of the asset being created. This could be especially difficult to define in design-build contracts, where services are bundled and integrated, rather than segmented. Industry practices such as performance bonuses, change orders and post-completion warranty work could also complicate these decisions.

For publicly traded companies, the new reporting requirements go into effect for the first annual reporting period beginning after Dec. 15, 2016, or the year beginning Jan. 1, 2017, for many public companies. Privately held companies may elect to wait until the first annual reporting period after Dec. 15, 2017.

While the deadline is still several years away, the time and expense involved in developing this information could be significant, so it's wise to begin planning soon. Call us today to discuss how these coming changes could affect you, and what you can do to prepare.

For more information, please contact **Tony Smith, CPA, CIT** or **Teri Samples, CPA** at 314.862.2070 or tsmith@muellerprost.com or tsamples@muellerprost.com.