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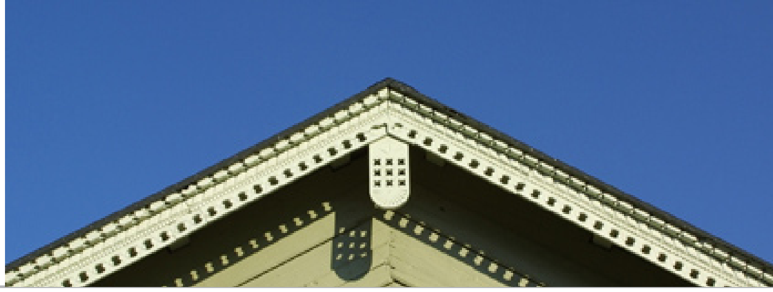

DIMENSIONS

Summer 2012

DISASTER RECOVERY AND BUSINESS CONTINUITY

Planning and Preparation Key to Mastering a Disaster

"Hope for the best; prepare for the worst."

When it comes to natural disasters and other business disruptions, that's sound advice — but it's often ignored. According to one major insurance company, 40 percent of businesses that don't have a disaster plan go out of business after a major loss such as a fire, break-in or storm.

Disaster planning and preparation can be particularly challenging for construction-related companies since contractors must consider not only their own facilities — trailers, shops, offices and IT systems — but also worksites where they share responsibility.

Whether you use professional disaster recovery planning services or take on this effort yourself, the key is to make sure your company can survive the unexpected.

Identify Risks and Effects

Begin with a business impact analysis to identify the possible risks your company might encounter — natural disasters, accidents, power outages, equipment or system failures, work stoppages, and so on. Next, identify critical business operations and systems, and quantify the potential impact disruptions would have.

Then examine your existing emergency procedures and identify the personnel and other resources you would need to restore critical systems after a disaster. This analysis can provide you with a list of action steps for improving the plan you already have.

Recovery Plan Basics

A disaster recovery plan must address both short-term and long-term recovery. First, it must identify and organize the individuals responsible for responding in an emergency and getting key business functions and systems operating again. In the longer term, it also must outline how you will return your company to its original capabilities.

Designate a team to manage the recovery efforts. This team's responsibilities should address emergency measures to protect life and property, and to restore key systems and business operations. For example:

- Who will be responsible for the physical security of company facilities and equipment in the event of a major storm or other disaster, whether natural or man-made?
- Who will check on the physical welfare of employees and their families?
- If employees need assistance, who will take the lead in seeing they get help?
- Who will notify employees not to report for work or to report to a different location?
- Who will see that critical data is retrieved from an off-site storage location?
- Who will communicate with clients and property owners during a crisis and its aftermath?
- Who will communicate with government officials and the news media, if necessary?

A disaster plan should also include advance arrangements for a backup office location, and secure offsite storage of employee records, contracts, financial and insurance records, permits, and other paper documents.

Information Systems Are Key

In today's technology-driven world, IT-related disasters such as power outages, system failures,

DISASTER RECOVERY AND BUSINESS CONTINUITY

Planning and Preparation Key to Mastering a Disaster, Cont'd.

viruses or cyber-attacks can be almost as devastating as a physical loss.

Surprisingly, though, only about half of the businesses in one recent survey had disaster recovery plans that addressed the loss of critical data.

Not long ago, even the largest contractors operated with a few main onsite servers. These would be backed up periodically with the tapes or disks stored securely offsite. Unfortunately, complacency often set in, and the eventual failure rates for such arrangements were generally quite high.

Today, this weakness can be easily overcome by using a remote data center that provides hosting services with full redundancy — in effect, running a complete backup of your system in real time. The use of such data centers has skyrocketed in recent years, and the costs are often quite reasonable considering the amount of risk they remove from your operations.

Even if you choose not to use a data center, you should take steps to protect hardware and software, and minimize the loss of valuable data. Key preventive steps include installing surge protectors, battery backups and duplicate servers in separate locations, along with necessary virus protection and firewalls.

Focus on Prevention

Even when your disaster recovery plan is updated and complete, you should review and revise it regularly — an annual review is a good benchmark. Planning ahead involves a little extra effort, but it can be essential to ensuring your company can survive a disaster and stay in business.

Contact us for assistance in developing or updating your disaster recovery plan.

MANAGING THE TRANSITION

Accurate Valuation Is Essential

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

Whether your goal is to pass on a family business to a new generation, transfer your closely held company to a group of key managers, or sell your business to an outside buyer, accurate valuation is an indispensable early step.

One compelling reason for a professional valuation is to determine the tax consequences of the sale, or the gift or estate tax ramifications if family members are involved. The valuation should be done by someone qualified to serve as an expert witness on business valuation, in case it becomes necessary to defend the valuation to the Internal Revenue Service.

Beyond the legalities, obtaining an accurate valuation is also a good business practice. If you are selling to an outside buyer, fair market value is the ultimate valuation standard — the business is worth whatever a buyer is willing to pay. But an objective valuation, coupled with a market analysis, can give you a more realistic picture of what to expect.

The current owner will naturally focus on the investment value of the enterprise, but a potential buyer will see only the income-generating possibilities. The two values can be quite different, and many owners are surprised to learn that an objective valuation doesn't match up with their expectations.

MANAGING THE TRANSITION
Accurate Valuation Is Essential, Con'td.

What to Expect

The valuation process typically starts with a review of the past three to five years of financial information, including tax returns and financial statements. Depending on the condition of the business, the valuator will then perform a market study of comparable companies based on earnings before interest, taxes, depreciation and amortization (EBITDA), along with cash flow and book value.

A key indicator that emerges from this analysis is the capitalization rate, which compares earnings with book value. Because it is based in part on EBITDA, the capitalization rate can be adversely affected by large swings in revenue from one year to the next, which will diminish the ultimate value of the business.

The valuator will very likely discount the value of the business further due to lack of marketability. Since there is typically a limited pool of buyers for a contracting business, with little large-scale merger and acquisition activity, the valuation is usually discounted to reflect this.

Another discount the valuator will probably apply is a minority interest discount. Most business transitions occur in stages, especially when handing over a business to family members or other insiders. Because the new owners will not have a controlling interest during much of the transition period, the value of their shares is significantly reduced.

Altogether, it is not uncommon for the valuation of the business to be discounted by somewhere between 25 percent and 35 percent due to the combination of limited marketability and the minority interest discount.

Gift and Estate Tax Considerations

When transitioning to family members, estate and gift tax issues are closely related to the valuation of the business. This has been especially true during the past few years due to temporary changes in the estate and gift tax exemptions.

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 temporarily upped the estate tax exemption to $5 million and $5.12 million per person for 2011 and 2012, respectively. The lifetime gift tax exemption also jumped to $5 million and $5.12 million for these two years. In 2013, unless Congress acts, the estate tax and gift tax exemptions will revert to $1 million.

Also for 2012, the maximum estate and gift tax rate is 35 percent. Assuming no congressional action, this will climb to 50 percent in 2013. The generation-skipping tax rate for gifts or trusts for grandchildren will also rise in 2013.

There have been various suggestions for modifying the gift and estate tax exemptions beginning in 2013, rather than allowing them to revert back to their previous levels. In addition, some members of Congress support legislation to eliminate valuation discounts for family-owned entities and to curtail the use of other popular estate tax planning strategies.

These uncertainties, combined with relatively low current business valuations, have encouraged many owners to move up their transition plans to take advantage of the current situation. Any decision to transfer business shares is highly complex, however, with many other factors in play. Therefore, you should do so only after extensive consultation with trusted advisors, including your accountant, financial, and estate planning professionals.

In our next issue, we will look at managing the details of the transition deal.

Call us today for more information on business valuation or other transition issues.

KEY FINANCIAL INDICATORS

What Matters to Lenders

The lending climate of the past few years has been unpredictable at best, and many contractors have found longstanding credit relationships suddenly in jeopardy.

To avoid unexpected surprises, it helps to know which financial indicators lenders watch most closely. Each institution will have its own standards and priorities, and their willingness to work with borrowers will vary. In general, though, the key financial indicators (KFIs) of most interest to bankers can be grouped into four main categories: profitability, cash flow, liquidity and leverage.

Profitability

The primary KFIs for measuring profitability are the percentage of profit to revenue (both gross and net) and return on equity (ROE).

Gross profit is often used to measure project performance. It is generally expressed as both an absolute number (revenue minus direct cost of work) and as a percentage of project revenue. Net profit is used to assess the overall performance of the business — it is calculated by subtracting indirect costs (or overhead) from gross profit. It too can be expressed both as an absolute number and as a percentage of revenue.

ROE demonstrates the relationship between earnings and the amount of equity invested in the business. It's calculated by dividing net profit (before tax) by the owners' equity in the firm.

Cash Flow

Accounts receivable, accounts payable, underbillings (revenue earned in excess of billings) and overbillings (billings in excess of revenue earned) all have an impact on your company's cash flow — and ultimately, on your ability to fund operations.

Loan covenants usually focus on several KFIs related to cash, including the cash demand period, which is the length of time that your company must be able to fund operations. This is essentially the difference between the time it takes to receive payment for completed work and inventory, and the time when you have to pay your creditors.

Top-performing companies reduce the cash demand period by minimizing underbillings, maximizing overbillings, reducing the amount of time it takes to collect receivables, and exercising prudent use of trade credit.

Liquidity

Liquidity indicators measure your company's ability to meet short-term obligations. Liquidity KFIs include current ratio (current assets divided by current liabilities) and working capital turnover — a measure of how aggressively you are using available funds to generate work. Working capital turnover is figured by subtracting current liabilities from current assets, and then dividing that figure into total revenues [revenue/(current assets – current liabilities)].

Leverage

Financial leverage indicators directly affect the company's risk profile and its ability to repay debts. They include the debt to equity ratio (total liabilities/owners' equity) and the revenue to equity ratio (revenue/owners' equity).

One other group of commonly watched financial indicators relates to backlog. While most contractors have a good sense of what their backlog is — and what it should be — backlog is not usually included in most lenders' loan covenants.

When starting a new lending relationship, it's a good idea to compare your last several years' financial statements with the bank's desired ratios to see if they are realistic for your situation. If not, talk to the lending officer about modifications, or talk to other lenders to find one willing to work with you.

Maintaining adequate credit capacity is essential. Call us to discuss ways to improve your company's attractiveness to lenders.

Fraud Prevention and Detection in a Lean Operation

If like many contractors today your company has been operating with a downsized administrative staff for the past few years, one unfortunate side effect could be an increased risk of fraud. This makes internal fraud controls more important than ever.

In general, there are two types of internal controls — preventive and detective. Preventive controls — such as limiting the number of people who have access to certain assets and using tools like pre-numbered purchase orders — are generally stronger. Detective controls, which alert you to fraud after it has occurred, tend to be less effective.

Preventive controls are generally preferred but, in today's lean operations, they are not always feasible. For example, a transaction that once involved three people — an accounts payable clerk, an officer who signed the check, and an accounting staffer who reconciled accounts — may now be handled by one person alone. Or, materials that were formerly ordered by a designated purchasing department may now be handled by individual project managers.

Such blending of duties should be avoided if possible. However, if adequate segregation of duties is not practical, at least put strong detective controls in place to discover potential fraud as early as possible. This means the owner, controller or CFO should personally supervise purchases, monitor bank and credit card statements, and compare financial statements, payroll tax deposits, general ledger entries and other supporting documents.

Focus on the most critical processes and highest risk assets first. Make sure all transaction types are assessed and that transaction approval authority is assigned at the appropriate level.

Even sophisticated internal controls may not be enough to stop a truly determined thief, particularly if the thief is a trusted employee. But paying extra vigilance to internal controls can make your lean operation far less vulnerable to fraud.

Detective controls tend to be less effective.