On-Site

WINTER 2021

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ALL YEAR LONG

Smart budgeting practices for construction companies

Most business owners would tell you that the only thing harder than setting a company budget is sticking to it. Contractors face the added stress of managing multiple project budgets while still handling their overall business expenses.

To keep your construction company's cash flow healthy and your business on course for a profitable year, you've got to do the legwork necessary to create an accurate, reasonable budget and then employ smart budgeting practices all year long.

Calculate spending before revenue

You may be tempted to begin the budget-setting process by estimating total revenue for the year. A better strategy, however, is to start with projected spending. After all, spending is something over which you can exert a little more control.

Divide your expenses between hard and soft costs. As with individual project budgets, hard costs are the "brick and mortar" expenses directly related to physically completing work — such as equipment, materials and labor. Soft costs are indirect costs (such as insurance, fees and certifications) and overhead costs (such as office rent and furniture).

When you divide your budget into these two categories, you'll have a better sense of which line items are variable and can be adjusted and where to apply cost control measures. Throughout the year, check back on hard and soft costs to see whether new or overlooked ones are threatening the budget. You may also be able to cut some items as circumstances allow.

Evaluate historical trends, data

Taking last year's budget and adjusting the numbers for inflation is another enticing shortcut, but doing so is typically ill advised. You can and perhaps should, however, review your construction company's historical data to better identify relevant trends that may affect your budget throughout the year.

For example, study your company's income statements from the past several years. Start with the most recent one and compare each line item to past statements. If you detect an upward or downward trend for a certain expense, adjust the line item accordingly.

Such a review also presents the opportunity to determine where your operation has consistently spent above or below allotted budget constraints and whether you need to readjust spending, cut back operations or look for ways to raise capital.

A DIFFERENT ANIMAL: PROJECT BUDGETS

They may be the same species as an overall business budget, but project budgets are a different animal. Here are a few strategies to consider when creating a feasible project budget:

Factor inflation for indirect costs in bids. While indirect costs can be tricky to identify and calculate, their impact on a project is very real. When preparing a bid, estimators typically allocate a percentage of the total cost for insurance, fleet maintenance and other indirect costs. Be sure to periodically update these costs in your estimating system to ensure you're not forgetting any and that they reflect current inflation rates.

Include a buffer for unexpected expenses. Every contractor is vulnerable to cost overruns. Unforeseen circumstances, such as bad weather or substandard site conditions, can delay projects and hurt budgets. A good course of action is to reserve at least 5% of the project budget for surprise costs.

Research project financing. Make sure a project owner will likely be securely financed before submitting a bid. By the same token, take care that your construction company can accept the contract and remain financially stable until you receive payment.

An additional helpful tip: To uncover a trend for a line item, divide the current number by the previous year's number and subtract 1. The answer is the growth rate. Repeat for other years' income statements and chart the results to visualize the trend.

Be realistic about gross margin

Calculate your gross margin, which is the difference between net sales revenue and the cost of goods sold (COGS). In construction, COGS typically refers to direct costs, such as materials and labor, as well as indirect costs or general conditions.

Compare your gross margins from previous years with the average gross margins for the industry segments in which you perform work. You should be able to locate this data through trade publications or industry associations. Knowing these numbers will help you refine your current budget and set prices for jobs as the year goes along.

When it comes to projecting gross margin, temper optimism with pragmatism. A 5% sales growth last year doesn't automatically translate to 5% growth this year. Consider other qualifying factors such as staff turnover, current market costs of labor and materials, and the need to buy or lease new equipment.

Also contemplate external factors, such as the overall economy and local market demand. The COVID-19 pandemic has had varying effects on construction. In some cases, projects have been shut down or put on hold. However, an increased demand for single-family housing and home renovations may create more work in other areas, depending on your specialty.

Make it a habit

Without regularly revisiting the budget, you'll be left to guess whether your construction business is on the right track as the year rolls along.

Set dates in your calendar, at least quarterly, to sit down with your fellow business owners (if any) and top managers to look over the budget. These periodic reviews will help you adjust as necessary to adapt to emerging trends and challenges — and to remain competitive and, one hopes, profitable.

Last, but not least, involve your CPA in the budget-setting and management process. He or she can help you identify and analyze financial trends, as well as implement strategies to guard against risk and leverage opportunities. ■

LET PROFIT FLOURISH, NOT FADE AWAY

A gradual decline in expected gross profits over the course of a project is known as "profit fade." It not only undermines financial performance, but also may raise red flags with sureties and lenders. For these reasons, contractors face an operational imperative to recognize why profit fade happens and know what steps they can take to stop it.

Common culprits

So, what can cause profit fade? Many things, often in combination. Poor or overly optimistic estimating, inaccurate job costing, and unbillable extra work or change orders are all common culprits. Unsatisfactory performance by subcontractors or suppliers can be a cause, as can lax project management or field supervision on the part of the general contractor. Adverse weather conditions or other unexpected jobsite challenges may also contribute to the problem.

It's normal to experience any one of these issues over the years in the due course of business. However, if your jobs regularly suffer from profit fade, you should formally and directly address it.

Direct and indirect costs

Another major contributor to profit fade is overlooking the nuances of direct and indirect costs. Direct costs, of course, pertain directly to the project at hand. Indirect costs relate to contract performance but on a wider scale. They can be trickier to deal with because they're often hidden from view.

Take, for instance, insurance expenses. They often lead to profit fade because premiums tend to change from year to year. But, with a little effort, you can parse workers' compensation and liability costs into an hourly rate for different trades and incorporate this data into labor cost calculations.

You can take similar measures with vehicle insurance. Price the cost of drivers at an hourly rate different from that of nondrivers. Apply a mileage rate for gasoline and depreciation by estimating how many miles a driver will have to travel on a typical day. From there, you should be able to integrate vehicle insurance costs into hourly calculations so you can cover all true costs — and have enough to cover overhead and the profit margin.

Other ideas

There are a variety of other ways to prevent fade. For starters, evaluate your estimating and job costing systems and procedures to be sure they're accurate and complete. Consider using more conservative assumptions in your estimates. Build in contingent costs to provide a cushion against unanticipated delays and expenses.

Also, analyze past jobs to look for patterns and trends. Is there a correlation between profit fade and certain factors, such as job type, location, contract size or customer? Is profit fade more likely to occur on jobs involving certain estimators, project managers or other personnel? Talk to employees

involved with those jobs to identify any factors that caused actual costs to exceed estimated costs. Use this information to improve your estimates and management practices on future jobs.

> Be sure your contracts clearly define the nature and scope of the work you're expected to perform.

Your contracts may be part of the trouble, too. Ambiguous or poorly drafted language can quickly lead to unanticipated costs — particularly if you and your client have different expectations regarding the work involved. Be sure your contracts clearly define the nature and scope of the work you're expected to perform and provide straightforward change-order procedures to ensure that you're compensated for extra work.

Before you execute any contract, develop a thorough, realistic budget. Tie it to the original cost estimate and establish procedures for reporting actual and expected completion costs as the job progresses.

Finally, carefully monitor a job's progress and investigate discrepancies between budgeted and actual performance. Regular work-in-progress reports can help you track:

- Contract prices,
- Amounts billed,
- Costs incurred to date,
- Projected final costs, and
- Estimated gross profits.

Continually monitoring this information allows you to spot problems early and resolve them before they do irreparable harm.

A key priority

There are few worse feelings in the construction business than giving your all to a project only to see the profit margin gradually shrink to a minimal amount or, worst of all, disappear completely. Prioritize the prevention of profit fade. ■

MANAGING BACKLOG IN AN UNCERTAIN ECONOMY

When projects stalled across the country during the initial weeks of the COVID-19 pandemic — some indefinitely because of lost funding — the construction industry became increasingly nervous about backlog.

As of this writing, construction backlog seems to be rebounding, though projects in some areas are still being postponed or canceled for various reasons. During these uncertain times, you can better prepare for what's to come by monitoring not only your own company's backlog, but also that of the industry.

Assess the situation

We all know how important backlog is to a construction business. Having a healthy amount of work scheduled but not yet started is a key indicator of financial strength. A diminished backlog, on the other hand, implies the contractor is running out of work.

The fact that backlogs are falling industrywide indicates that fewer projects are coming to market. Many contractors may respond by bidding on more projects than usual or bidding on those outside their normal scope of work. With more contractors vying for the same projects,

some may feel forced to bid jobs at lower margins, which in turn negatively impacts profitability.

Build backlog

It's possible to maintain or even grow your backlog in a slowly recovering economy without lowballing bids. Here are a few strategies to consider:

Watch market conditions. To get on the right bid lists, pay attention to construction backlog in the regions or sectors in which you typically work or could work. Doing so will shed light on where demand is high and which market sectors are healthy.

Explore diversification. Look into the feasibility of diversifying the construction services your company offers. This is, of course, not a risk-free strategy. You may need to bring in new talent or invest in additional equipment.

Focus on relationships. Regular communication is key to keeping relationships fresh with partners and those who make important decisions on potential jobs. Key contacts can include general contractors (especially if you're a subcontractor), consultants, architects and engineers, and developers.

Sell your unique value proposition. Identify what you do better than anyone else. First and foremost, promote your approach to the safety of your workers and the general public — including measures taken to prevent the spread of COVID-19. Plug other demonstrable advantages of your business, such as stellar customer service, niche expertise and experience, and speed of work.

Bid first. Among the easiest ways to win more bids is to submit first. This way, your proposal becomes the standard against which others are compared. To get early leads on projects in the pipeline, tap into your professional networks regularly and visit online construction bidding marketplaces.

Don't just survive, thrive

When competition for projects heats up, some contractors feel pressured to bid on every job they can find, just to have work and keep staff on board. However, your company should bid only on projects that you have a high chance of winning and that will likely be profitable.

> Pay attention to construction backlog in the regions or sectors in which you typically work or could work.

Avoid projects that are outside of your niche or in locations where you won't have the workforce or resources to feasibly fulfill the requirements. Above all, avoid the temptation to bid too low and potentially lose money if you're awarded the work. ■

PARAMETRIC INSURANCE SEEKS TO BRIDGE COVID-19 GAP

The COVID-19 crisis has revealed a significant insurance protection gap in the construction industry (and others): communicable disease. Many contractors found that their business interruption insurance and other policies didn't cover pandemic-related project shutdowns because of either exclusionary language or the need for physical damage or a physical trigger element, such as flooding.

One type of policy that has been gaining traction in light of the gaps left by traditional plans — including pandemic-related coverage — is parametric insurance. Construction companies can buy one of these policies to protect their balance sheets, rather than property, when projects are exposed to qualifying events that cause unexpected delays or expenses.

The basics

While traditional insurance pays claims for loss of or damage to physical assets, parametric insurance payouts are triggered by an event, such as bad weather. It provides a solution for companies requiring immediate financial relief when an adverse event delays or otherwise negatively impacts a project but doesn't necessarily cause physical damage.

The concept is relatively simple. The insured and insurer agree on predetermined, measurable parameters as well as the sum to be paid when those parameters are triggered. Once the parameter thresholds have been met, and measured by a neutral third party, the payout is disbursed to the policyholder.

For instance, if high winds temporarily stop a project, and the wind speed reaches a predetermined level that's confirmed by a nearby weather station, the policy is triggered and the predefined sum is automatically paid. There are no deductibles and no need for adjustments, negotiations or settlements. Another example is when the ambient air temperature drops below a predetermined level and interrupts the concrete mixing and curing process.

Larger strategy

Parametric products can be part of a larger strategy to protect cash reserves, lines of credit and surety capacity on projects.

In the past, construction companies have used parametric coverage to minimize the gray areas presented by traditionally underinsured risks, such as project disruptions caused by extreme temperatures and catastrophic events such as wildfires, earthquakes and flooding. Now, some are considering parametric contracts that protect against risks related to viral outbreaks, public health crises and government-mandated shutdowns.

Supplemental plan

Parametric coverage isn't a one-size-fits-all solution to insurance needs, and it's not intended to replace traditional plans. Rather, its purpose is to supplement other policies by providing an additional layer of protection in the face of specific adverse events. To determine whether parametric insurance might be right for your construction company, contact a qualified insurance rep and consult your CPA on the cost impact. ■

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Laying a Firm Foundation for a Successful Digital Transformation

As the construction industry continues to grapple with the effects of the COVID-19 pandemic, some in the industry are looking for digital solutions to help create efficiencies and position their companies for future growth. The digital transformation may seem overwhelming especially when weighing the investment in technology and training against the bottom line. Here are several key steps that companies can take to lay a firm foundation for the transition.

Conduct a strategic review of the organization's current business model to determine how digitalization will benefit your organization. There is no "one size fits all" solution. Start by looking at your long-term strategic business plan and consider: how do you interact with stakeholders, how large is the organization, what is your reach — regional, global or international, and perhaps most importantly, what is your current digital readiness? Then, create a long-term digitalization strategy that supports your business model and helps solve pain points by examining specific use cases where technology may help reduce costs.

Depending upon your particular pain points and digital readiness, you may want to start with technologies that are easier to implement and offer more immediate tangible results. For example, drones can be deployed to monitor job sites or perform some types of inspections. Workers can be issued wearable devices to help create efficiencies in movement, and radio-frequency identification (RFID) chips can be used on equipment to help track performance and map efficient use of resources across multiple job sites. Implementing Business Information Modeling (BIM) may ultimately provide a framework for linking all of the data to help gain maximum efficiencies by connecting all of the technologies used across the project lifecycle.

Of course, any digital transformation strategy must include the human element. The construction industry is no stranger to work force issues, and the addition of technology introduces requirements for new skill sets and perhaps even some restructuring within a company. Training and change management for the existing workforce will be needed to maximize the effective use of technology. As the technology provides data for analysis, key individuals will be needed to help provide that analysis. The current economic crisis offers a critical window to "skill up" the current workforce and to attract digital talent from other technology fields.

As the COVID-19 pandemic continues to impact the industry, it also offers an opportunity for the industry to better understand how to leverage technology to improve efficiency and to take concrete steps toward implementing a clear digital strategy to support a robust recovery.

For more information about LaPorte's Construction Industry Group and the audit, tax, and consulting services we offer, contact group leader Tracy Tufts, CPA, CCIFP at ttufts@laporte.com.