Construction

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Know your financial pulse: It could save your company's life

Just as a wise patient undergoes regular medical checkups, your construction firm should have regular financial checkups. Why? Banks and sureties are already paying attention to your company's financial vital signs, so it makes sense for you to track them as well.

Not only will doing regular checkups help you address problems while it's early enough to do something about them, but doing so will also help you stay in compliance with loan covenants and maintain your bonding capacity. (See "Negotiating covenant agreements with lenders" on page 3.)

A holistic approach

Just as taking your blood pressure alone tells you little about your overall health, no single financial indicator tells the whole story about your construction company's well-being. There are numerous ratios and other metrics you can use, but it's important to select a manageable number of indicators that make sense for your company and measure its performance in various areas.

A good source of such benchmarking information is the Construction Financial Management Association (CFMA), but you can also obtain data from other national, regional and local industry groups. CFMA's *Construction Industry Annual Financial Survey* collects data on 20 key financial ratios and provides overall and best-in-class averages for the construction industry as a whole, as well as for specific regions and industry sectors. The ratios are divided into four categories: profitability, liquidity, leverage and efficiency.

Even if your company seems to be thriving now, too much debt or inefficient use of capital or assets can signal trouble down the road.

It's important to measure your company's performance in all four areas. Even though profitability is every company's ultimate goal, *liquidity* is critical, especially in today's economic environment. There are countless examples of construction firms that were highly profitable on paper but failed because of inadequate cash flow. Leverage and efficiency also are important concerns. Even if your company seems to be thriving now, too much debt or inefficient use of capital or assets can signal trouble down the road.

Commonly used ratios

Here are several examples of key financial ratios for construction firms:

Return on equity (profitability). As a general rule, the higher this ratio (net earnings/total net worth) the better. But in some cases, a high ratio may indicate that the construction company is undercapitalized or has too much debt.

Negotiating covenant agreements with lenders

The credit crisis has caused most lenders to tighten loan covenants. Loan agreements often require contractors to maintain their current ratios, debt-to-equity or other financial ratios at certain levels. In the past, lenders typically built some cushion into loan covenants to give contractors some "wiggle room" before they fell out of compliance. In today's struggling economy, however, lenders are becoming less lenient. For this reason, it's critical that you monitor key financial ratios closely.

It's also important to negotiate loan covenants with your lenders. Every construction business is different, and no one knows your business better than you do. To obtain the best terms, provide your lender with information that supports appropriate financial ratios for your business.

Current ratio (liquidity). One of the most popular ratios for contractors, the current ratio (current assets/current liabilities) measures a contractor's ability to satisfy its short-term liabilities with cash and other relatively liquid assets.

Working capital turnover (liquidity). This ratio (revenue/working capital) indicates the amount of revenue supported by each dollar of net working capital used. A higher ratio may signal a need for additional working capital to support future growth.

Debt-to-equity (leverage). This ratio (total debt/net worth) measures the degree of leverage you use. A higher ratio allows you to earn more on your invested equity, but also exposes you to greater risk.

Months in backlog (efficiency). This ratio [backlog/(revenue divided by 12)] shows the number of months it will take to complete all signed or committed work. A lower ratio may mean the company needs new contracts to maintain constant revenue in the future.

Monitoring these and other financial ratios allows you to compare your company's performance to that of other construction firms in your industry sector and region. By watching for changes in your financial ratios over time, you can spot negative trends and identify opportunities for improvement.

Key performance indicators

Financial ratios are really just a subset of key performance indicators (KPIs). KPIs also include other financial measures, such as unapproved change orders, underbilling, profit fade and overhead creep, as well as nonfinancial measures, such as employee morale, schedule variances or customer satisfaction.

Work-in-process (WIP) reports are particularly valuable. Not only do they reveal potential problems, but they also help you identify strategies for dealing with them. Suppose, for example, that an analysis of your WIP reports shows a pattern of gross profits that shrink over time ("profit fade") or that gross profits on current jobs are consistently lower than on completed jobs. There are several possible reasons for this, including poor estimating or ineffective project management.

Underbilling is another trend that may indicate management deficiencies. If billings aren't keeping pace with a job's progress, it may be a sign of cost overruns, lax management or sluggish billing practices.

Learning about profit fade, underbilling or other problems early allows you to address the underlying causes before they do irreparable harm.

Your financial health plan

All construction companies should have a plan for collecting key financial and nonfinancial data, monitoring financial ratios and other KPIs, and using those indicators to improve their businesses. By monitoring ratios and other key performance indicators, you can detect early warning signs of financial health problems before they do permanent damage.

Your financial advisor can help you put together a set of metrics that make sense for you based on the nature of your business and your company's particular circumstances. ■

What's so captivating about captive insurance?

Captive insurance is a type of self-insurance that can help all types of businesses reduce costs. But is it right for your construction company? Maybe, maybe not. Let's see how setting up your own subsidiary — or captive insurance company — can help you reduce costs and gain control of many insurance decisions.

Captivating benefits

Captive insurance offers contractors a way to be more involved in loss control, claims management and risk financing. For instance, the close connection between the contractor and the captive enables them to settle claims quickly.

There are other reasons why you might want to create a captive, as well. Here are four:

1. Because the company owns the captive insurance company, it benefits from any investment or underwriting profits resulting from the captive.
2. If a group of companies forming the captive band together to purchase traditional insurance or other services, the group can benefit from lower costs through group purchasing.

3. Because a captive insurance company serves fewer customers and is set up by the insured, it will naturally be more responsive than a large insurance firm serving thousands of clients.
4. Insureds may also be able to reduce the chances of future accidents by scrutinizing loss reports and being committed to follow up with managers to improve job safety.

Under a group captive arrangement, companies pool financial, business and insurance risk into one self-insured retention level and buy an aggregate stop-loss policy.

Moreover, because the captive is at least partially owned by you, the insured, premiums are easier to control and, in the absence of unanticipated liabilities, are likely to be lower and more stable in the long run. Plus, premiums can be determined by *individual loss experience* as opposed to industry group or other classifications.

Establishing a captive

Setting up a group captive insurance company can be a viable option if your company has at least $200,000 or more in annual combined premiums. But the savings generally favor companies with annual premiums in excess of $1 million for automobile, umbrella, general liability, property and casualty, and workers' compensation insurance.

Under a group captive arrangement, companies pool financial, business and insurance risk into one self-insured retention level and buy

an aggregate stop-loss policy. In buying the policy, each company commits itself to sharing a portion of the other parties' liability.

Group arrangements can vary in rules and structure, however. Some captive insurance companies require annual combined payments of as little as $50,000. Group captives normally limit their size to 80 or fewer members, with some having fewer than 10 members.

Most captives are set up for property and casualty risks, so the claims that go to a captive insurance company tend to be larger and less frequent. Some companies may find that letting a captive handle only part of their risk and relying on traditional insurance for other areas makes sense. For instance, the high frequency and relatively small risks associated with health care are sometimes best managed through traditional insurance.

The location of a captive and the tax consequences of that location are two important factors to consider when choosing a captive. While many companies find locating their captive insurance companies in the United States advantageous, many group captive insurance companies are located offshore. This is because no taxes are paid on any of the members' earnings as long as the money remains offshore.

Taxing the captive

Companies that belong to a captive can generally deduct their premiums if they don't control the captive. Tax courts have upheld a company's right to deduct premiums paid to a captive it owns if the captive writes a significant amount of insurance for customers other than the parent company.

To take the deduction, the insured must be able to prove that risk was actually transferred. Blending conventional and captive insurance into a single policy is one way to transfer risk and qualify the entire policy for deductions.

The timing of loss deductions is also critical. Contractors generally prefer to take deductions in advance for expected losses. Keep in mind, though, that the IRS doesn't want companies to deduct losses for self-insurance until claims are actually paid and can deny these deductions during an audit.

A captivating incentive

In today's economy, the thought of reducing costs may be just the incentive you need to find out what's so captivating about captive insurance. Talk with your tax or financial advisor about whether captive insurance is right for your construction business. ■

Don't wait!

Time's running out on certain tax breaks

In the wake of the American Recovery and Reinvestment Act of 2009 (ARRA), contractors stand to benefit from not only spending initiatives for infrastructure and other construction projects, but also several tax incentives. Some of these incentives are available for a limited time, however, so start planning soon to take advantage of them.

Bonus depreciation

One of the most valuable incentives for contractors is ARRA's extension of 50% bonus depreciation through the end of 2009. This tax break allows you to take *additional* first-year depreciation deductions — for both regular and alternative minimum tax (AMT) purposes — equal to 50% of the cost of *new* construction equipment.

It also applies to most other depreciable business property with a recovery period of 20 years or less — such as computers, office furniture, fences and outdoor lighting — as well as to computer software. If you lease office space, you can even claim bonus depreciation for leasehold improvements, such as carpeting, light fixtures, partitions and office reconfiguration costs.

Enhanced expensing election

ARRA also extends the enhanced Section 179 expensing election to tax years *beginning* in 2009. The election allows you to take a current deduction for as much as $250,000 in newly acquired assets that otherwise would be depreciated over several years under the Modified Accelerated Cost Recovery System (MACRS). The election is intended to benefit smaller businesses, so it's phased out on a dollar-for-dollar basis once total acquisitions of Sec. 179 assets for the tax year exceed $800,000.

Unless Congress extends the election again, the Sec. 179 limits will revert to previous levels for tax years beginning after 2009 ($125,000 and $500,000, respectively, indexed for inflation).

Plan asset expenditures

Consider making significant asset purchases soon to take advantage of bonus depreciation and the enhanced expensing election. Keep in mind that many assets will qualify for both tax breaks, but bonus depreciation is available only for *new* assets, while the expensing election applies to both new and used assets. Also, if you're on a fiscal year, you can expense qualifying assets placed in service any time during your tax year *beginning* in 2009, but you can claim bonus depreciation only for assets placed in service during calendar-year 2009.

Here's an example of how you might benefit from these two tax breaks. Let's say you purchase $400,000 in new construction equipment during 2009, all of which is classified as five-year property under MACRS. Ordinarily, you'd deduct 20% of the cost, or $80,000, in 2009. Assuming a 40% combined tax rate, this would generate $32,000 in tax savings.

But instead you could elect to expense $250,000 in equipment costs under Sec. 179 and claim 50% bonus depreciation for the remaining $150,000. This would allow you to deduct $325,000, boosting your 2009 tax savings to $130,000.

If you can't take advantage of bonus depreciation this year or you expect to report a loss on your 2009 income tax return, ARRA permits you to accelerate certain refundable tax credits, including AMT credits, in lieu of claiming bonus depreciation.

Act now

ARRA's depreciation-related tax benefits offer big tax savings to contractors planning significant capital expenditures, but it's important to start planning these expenditures soon. Remember, it's not enough to spend the money during the 2009 tax year. To qualify for Sec. 179 expensing or bonus depreciation, assets must be placed in service before these tax breaks expire.

But also be careful to consider the bonding and banking effect of any major asset acquisition before proceeding — liquidity and leverage ratios could suffer. ■

FAR-reaching rules for government contractors

If your company performs work for the federal government, it's critical for you to become familiar with the recently revised Federal Acquisition Regulation (FAR). All federal contractors are now required to disclose certain overpayments and legal violations. And contractors involved with larger projects must implement rigorous business ethics programs and internal control systems.

Mandatory disclosure

The new rules impose mandatory disclosure requirements in place of the previous *voluntary* disclosure system. Certain disclosure requirements are limited to contracts or subcontracts in excess of $5 million with a performance period of 120 days or more. But one provision makes nondisclosure by *any* prime contractor grounds for suspension or debarment.

To comply, you must disclose to the government certain procurement-related criminal offenses — including fraud and bribery, violations of the civil False Claims Act and significant overpayments. Because disclosure is required for three years after final payment is received, you should look back at contracts completed in the last three years for any credible evidence of such violations.

Ethics and internal controls

With limited exceptions, the revised FAR imposes stricter ethics and internal control requirements for contracts or subcontracts in excess of $5 million with a performance period of 120 days or more. In addition to having a written code of business conduct, you must "exercise due diligence to prevent and detect criminal conduct" and promote an ethical culture. You also should have an ethics awareness and compliance program that includes effective training and periodic communication.

In addition, the revised rules spell out several "minimum" internal control requirements, including assignment of responsibility, periodic reviews, a hotline or similar reporting mechanism for suspected fraud or embezzlement, disciplinary action for improper conduct, and exclusion of violators from management.

Meeting the standards

If you're currently under contract with the federal government or you plan to bid on federal projects in the future, make sure you're in compliance with FAR disclosure requirements and that you have in place an ethics program and internal controls that meet the new standards.

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