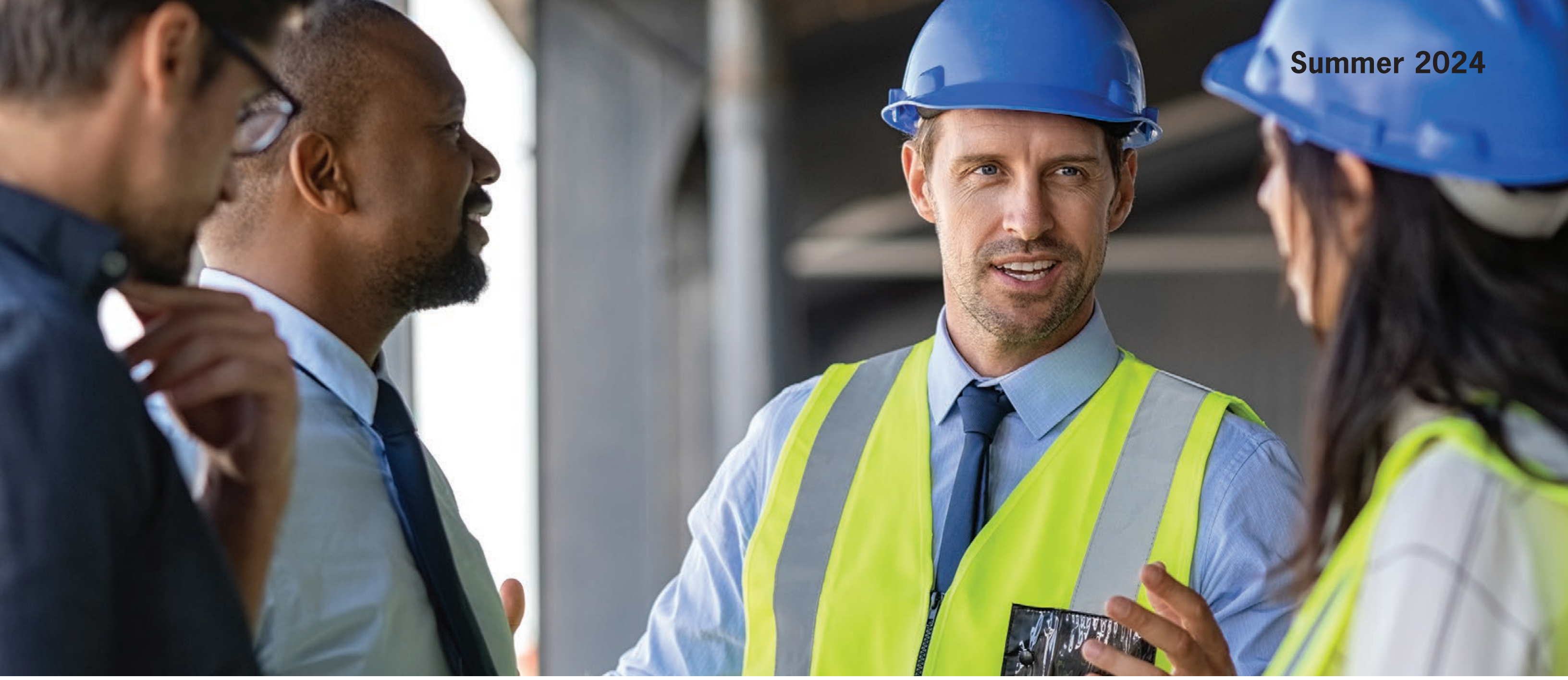
Summer 2024



CONSTRUCTION INDUSTRY ADVISOR

What are your construction company's true labor costs?

Protecting your construction business from ransomware

Be mindful of backlog: yours and the industry's

Integrated project delivery model offers many benefits

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What are your construction company's true labor costs?

The construction industry is more competitive than ever, so accurate estimates are critical. Labor is usually among the largest costs associated with any project; even small errors in this part of an estimate can turn a seemingly profitable job into a potential loser.

Yet knowing your payroll costs alone isn't enough. You've got to know your *true* labor costs. And how do you determine that? By using a metric called labor burden rate.

Accounting for everything

Strictly defined, labor burden rate for an employee or class of employees is total indirect labor costs as a percentage of direct labor costs. (For the purposes of this calculation, we'll consider payroll to be direct labor costs.)

Typically, the rate ranges from 30% to 40%, though it can be even higher for union contractors. For example, say you pay an employee $30 per hour. If your labor burden rate is 40%, then your true labor cost for that employee would be $30 + (40% x $30) = $42 per hour.

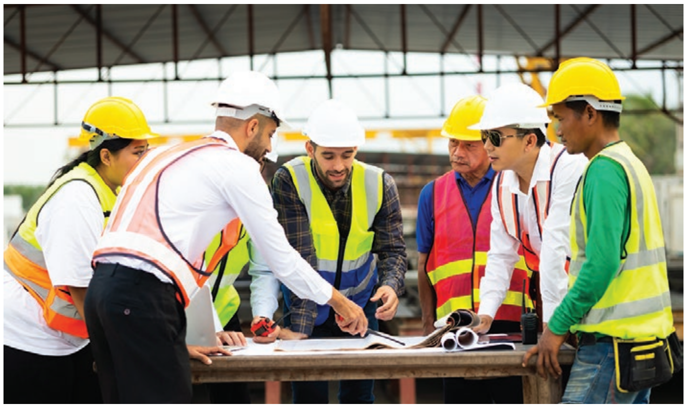
To accurately calculate labor burden rate, you must add the various indirect costs you incur in connection with an employee or class of employees. These include but aren't limited to:

State and federal payroll taxes. Included here are taxes levied under the Federal Insurance Contributions Act (FICA), Social Security and Medicare, as well as unemployment taxes. The employer's share of FICA taxes is 6.2% for Social Security and 1.45% for Medicare, and the current federal unemployment tax rate is 6%.

Fringe benefits. It's critical to identify all that your construction company sponsors. Common examples include medical, dental and vision insurance; life and disability insurance; matching retirement plan contributions; bonuses and profit-sharing; and tuition reimbursement or student loan debt assistance.

Commercial insurance. These costs include the premiums you pay for policies covering things such as workers' compensation, general liability, professional liability, vehicles and pollution.

Training. If your construction business provides training of any kind, including safety training, you need to track its costs closely and factor them into your labor burden rate.



Job-related clothing, safety gear and tools. Does your construction company provide any of these things to workers? If so, you must itemize their costs and apply them to labor burden rate.

Company-provided vehicles, cellphones and tablets. Many construction businesses maintain a fleet of vehicles, and some provide employees with mobile devices. Costs associated with these factor into labor burden rate as well.

Tips for reducing workers' compensation insurance costs

Although payroll is undoubtedly a huge factor in calculating labor burden rate (see main article), don't underestimate the impact of workers' compensation insurance costs. These can be substantial for construction companies. Here are some tips for reducing workers' comp costs:

- Properly classify employees; the more who are deemed to be in high-risk jobs, the higher your premiums will be.
- Double-check the accuracy of your experience modification rate; as you may know, this is the metric that your insurer uses to set your premiums based on your construction company's loss history.
- Develop a solid safety program; the best way to reduce workers' comp costs is to avoid accidents and injuries.
- Establish a return-to-work program; such programs gradually reintegrate injured employees into the workforce, typically through part-time or less physically demanding work, to minimize the amount of time they're off the job and reduce workers' comp claims.

Nonproductive time and activities

Along with identifying direct and indirect costs associated with employees, you need to account for "nonproductive" time and activities. This is essentially paid time off, such as vacations, sick days and holidays, as well as activities not performed on a jobsite, such as attending specialized training or in-office meetings.

Why? Because the hourly pay rate you use in estimates must sufficiently cover the costs of employees' productive time *and* their nonproductive time.

Suppose, for example, that Joe, a construction worker, earns $30 per hour. Assuming he's paid for 40 hours per week, 52 weeks a year, for a total of 2,080 hours, his annual salary is $62,400. Next assume that, after accounting for taxes, benefits and other indirect costs, his employer's total cost associated with Joe is $78,000 per year or $37.50 per hour ($78,000/2,080).

But Joe doesn't spend every one of those 2,080 hours working on "chargeable" construction projects. Let's assume he's paid for a total of 200 hours per year for nonproductive time and activities, such as vacation, sick days, holidays, training and company meetings. That means Joe's total productive — that is, chargeable — time is 1,880 hours per year. Thus, to ensure that it charges enough to cover Joe's annual costs, his employer should use a labor rate equal to $78,000/1,880, or approximately $41.50 per hour.

In this example, Joe's labor burden rate is $11.50/30, or 38%. The good news is it's usually unnecessary to calculate labor burden rates for every employee. In most cases, you can perform the calculation for each *class* of employees.

Key performance indicator

To help ensure accuracy, you'll need to recalculate your labor burden rates frequently — at least every six months. This is, of course, to account for pay rate fluctuations as well as changes to the costs of benefits, insurance and other contributing factors.

The value of calculating labor burden rates goes beyond better estimates. This critical metric can also serve as a key performance indicator to help with strategic decisions. For instance, if your rates are too high, you may have to seriously consider cost cutting. If they're too low, you may be able to add benefits or upgrade insurance. Your CPA can offer expertise and assistance with all the number crunching. ■

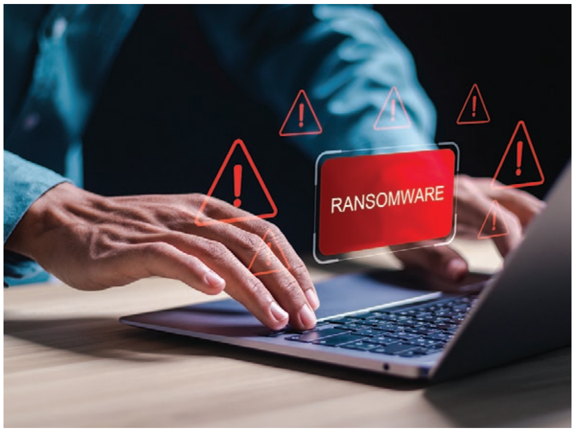
Protecting your construction business from ransomware

Construction businesses are an attractive target for ransomware attacks. In fact, according to a recent study by NordLocker, a developer of encryption software, the construction industry was targeted more often than any other industry from January 2022 to January 2023. For this reason, every construction company, no matter how small, needs to invest wisely in cybersecurity.

Why us?

There are many plausible explanations for cybercriminals' interest in the industry. Many construction businesses, especially smaller ones, have been slow to adopt robust cybersecurity systems and practices. In addition, construction companies tend to have widely dispersed workforces, so they often rely on cloud-based systems, many different mobile devices, and internet-connected vehicles and equipment — all of which are vulnerable to cyberattacks.

And then there's the data. Construction companies typically have access to a plethora of valuable information, such as customer bank account or credit card numbers, documents disclosing business expansions, bid records, and designs and specifications.



There's even the possibility of a ransomware attack creating safety hazards by disrupting building systems or tampering with vehicles or equipment. By creating such high stakes, hackers may believe construction businesses will be highly motivated to pay ransoms.

What is it again?

Just to review the concept, ransomware is a type of malicious software (commonly known as "malware") that typically infiltrates a company's computer network through:

- Phishing emails or texts (phony messages that fool employees),
- Downloads from fake websites,
- Compromised login credentials, or
- Removable devices (such as flash drives).

The malware encrypts the target's data, and the cyberattackers demand a ransom payment in exchange for the decryption key. Sometimes the scheme goes a step further and the hackers threaten to publicly release or destroy sensitive data if the ransom isn't paid.

What can we do?

To help prevent ransomware attacks or minimize their damage, consider the following best practices:

Conduct periodic cybersecurity assessments. Hackers are constantly changing their approaches, so contractors need to regularly reassess their exposure to ransomware risks and eliminate vulnerabilities. Maintain an inventory of your hardware, software, internet connections and data to identify potential entry points that could be exploited.

Implement strong backup practices. Secure backups can enable you to resume operations quickly if a ransomware attack captures or destroys your data. Your backup system should be encrypted and physically or digitally segregated from the systems being backed up.

Educate employees. Among the most important cybersecurity measures is to train employees to spot and avoid phishing emails and other threats. Also, require staff to use strong passwords, multifactor authentication and other techniques to prevent unauthorized access. If possible, restrict the use of employees' personal devices on your network.

Implement protective software. Various tools allow construction companies to monitor for and prevent intrusions. These include email filtering programs that flag malicious messages and prevent them from reaching their targets. In addition, ensure every computer and mobile device used for business purposes has the latest updates and security patches.

Manage third-party risks, too. For example, do any vendors or collaborators — such as architects, engineers or subcontractors — have access to your systems? If so, be sure that they've implemented strong controls as well.

Do we need cyberinsurance?

Even with a comprehensive cybersecurity strategy, there are no guarantees ransomware won't break through your defenses. For added peace of mind, consider investing in cyberinsurance to minimize the financial impact of an attack.

The right coverage can help pay for data recovery and system restoration, legal expenses, and even business interruption losses. Many insurers also provide resources to help companies better defend themselves against ransomware and other threats. These policies tend to be expensive, however, so you'll need to shop carefully.

Where do we go from here?

Cyberattacks such as ransomware schemes are becoming commonplace occurrences. So, construction businesses will likely need to allocate a larger percentage of their operating budgets to cybersecurity going forward. On the bright side, you may be able to better control these costs with a well-planned, comprehensive cybersecurity strategy. ■

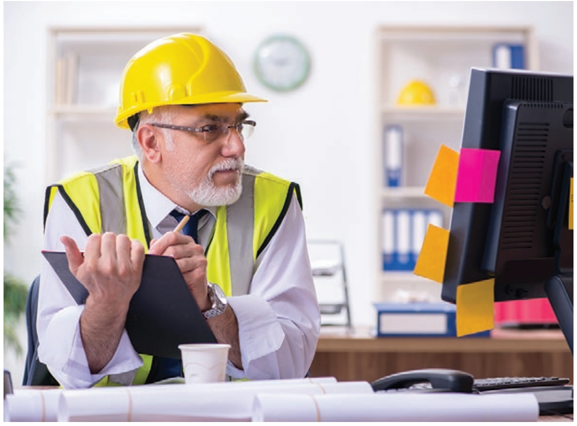
Be mindful of backlog: yours and the industry's

In the construction business, backlog is generally defined as the total value of all the projects a construction company has signed contracts for but has yet to complete. The construction industry itself also has a running backlog that serves as a leading economic indicator. It's important for construction business owners and their leadership teams to be mindful of backlog, from both perspectives, as the year goes along.

No guarantees

Among the most widely used source of industry backlog data for nonresidential building is the Construction Backlog Indicator published by industry trade association Associated Builders and Contractors (ABC).

In May 2024, for example, ABC reported that the backlog of work won but not yet started had



grown to 8.4 months in April from 8.2 months in March. That was, however, a slight decline from the 8.9 months posted a year earlier in April 2023. Naturally, these numbers are subject to change, but they can help you gauge the strength of the industry based on the amount of work scheduled to be performed.

Of course, a strong industrywide backlog is no guarantee that your construction business will have a healthy backlog. If yours is dwindling or nonexistent, it might indicate that competition is increasing in your market or your reputation is suffering.

A lengthy backlog is generally considered healthy, but there's a breaking point. Maintaining too long of a backlog might signal a future decline in customer satisfaction because completion deadlines will get pushed further and further out. It also could be a sign that you're underbidding.

Best practices

Backlog management is all about finding the proper balance among growing your book of business, keeping current clients satisfied, and maintaining or widening your profit margins. Best practices include:

Adjusting your bidding approach. Resist the temptation to bid for every project that comes along simply to build your backlog. Bid only on jobs that you're suited for, are likely to win and hold promise of solid profits.

Biting off more than you can chew can undermine cash flow and leave you without the funds needed to pay bills and service debt. You could end up damaging both your reputation and credit score.

Rightsizing your workforce. It's vital to match your staffing level to realistic expectations regarding upcoming projects. Maintaining too high of a payroll when jobs will likely become scarce will tie up substantial funds in idle workers.

On the other hand, overextending a minimal workforce can lead to injuries, workers' compensation claims, delays, poor employee retention and hiring troubles. Find the right balance based on your backlog and strategic objectives.

Maintaining strong client communications. Be upfront with clients about scheduling based on an honest assessment of your backlog. Misleading them will only create frustration, disappointment and bad word of mouth.

A lengthy backlog is generally considered healthy, but there's a breaking point.

That said, your backlog is your business — literally and figuratively. You don't have to go into too many details. Rather, reassure clients by sharing and reiterating plans and timelines for their respective projects.

Sustain and maintain

Few construction businesses can turn a profit, or even survive, taking a "one project at a time" approach. Building and carefully managing backlog is critical to sustaining revenue inflows and, thereby, maintaining a strong cash position. ■

Integrated project delivery model offers many benefits

The integrated project delivery (IPD) model of construction isn't new. But in an increasingly competitive and risky building environment, it's been gaining in popularity in recent years. As an alternative to the traditional design-bid-build construction model, IPD focuses on collaboration of all project parties throughout every stage of a job.

Shared risks and rewards

The American Institute of Architect's (AIA's) publication, *Integrated Project Delivery: A Guide*, defines IPD as:

> … a project delivery approach that integrates people, systems, business structures and practices into a process that collaboratively harnesses the talents and insights of all participants to optimize project results, increase value to the owner, reduce waste, and maximize efficiency through all phases of design, fabrication, and construction.

Under design-bid-build, parties tend to have quietly adversarial relationships, with each striving to minimize its own risk and transfer risk to the others. By providing that team members share risks and rewards — and be held clearly accountable for their contributions — IPD creates the potential for various benefits, including:

- Lower costs,
- Fewer errors and delays,
- Greater efficiency,
- Minimal waste,
- Reduced change orders, disputes and claims, and
- Higher profits for everyone.

There are many ways for parties to a construction project to structure an IPD arrangement. These include using a suite of contracts, such as those created by the AIA, or forming a limited liability company or similar entity. The key is for the owner, architect or engineer, and general contractor to collaborate from the outset, agreeing on project goals; target costs; and allocation of responsibilities, risks and compensation. In some cases, subcontractors and suppliers may be involved from the beginning as well.

To promote collaboration, decisions are usually made by unanimous consent, subject to arbitration or mediation in the event parties can't agree. Typically, parties waive liability for certain types of claims against one another, which promotes transparency and candid communication.

Technological impact

Building information modeling (BIM) is often used on IPD projects. BIM uses software to create a 3D or even 4D model of the intended building or structure, so parties can view it from different angles to better understand the spatial relationships between components.

It also incorporates specific materials and other building information into the design phase. This enables parties to create an optimally efficient schedule and visualize how potential changes would affect the job.

More than a little different

Naturally, IPD is far from risk free. It's legally complex, highly technologically dependent, and may require a major shift in mindset and culture for contractors accustomed to design-bid-build. So, if your construction company encounters one of these jobs, look before you leap. ■

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