Saltmarsh
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CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Dimensions

A CPA's Report for the Construction Industry

Fall 2015

Boom or Bust?

Watch for Signs of the Next Business Cycle

Experienced contractors never forget the inherently cyclical nature of the construction business. After each boom and bust cycle, surviving contractors invariably promise themselves they will not be caught by surprise again and they'll be more watchful for early signs of another slowdown.

Yet the most common indicators of construction industry activity like housing starts and building permits are, by their very nature, backward-looking. They measure activity in the recent past, but do not necessarily provide timely insights into coming conditions.

What's more, many economic indicators are broad and general in nature. They do not reflect local conditions, and may not pick up on smaller-scale trends that affect a particular type of project or a specific contractor or subcontractor specialty.

Useful Individual Indicators

No one can predict the future, of course, but there are some individual indicators that can help you track the health of your business. These indicators — especially changes in trends from month to month — can provide useful early-warning signs that tell you if you're growing too fast or getting too far out on a limb. Some examples include:

- **Balance Sheet Indicators —** Wise contractors always keep an eye on the balance sheet. Adding personnel and investing in additional equipment are necessary, but the best-managed companies try to keep debt down to reasonable levels and pay close attention to their debt-to-equity ratio.
- **Cash Flow Modeling —** When things slow down, the debt you incurred during boom times will still need to be serviced, even though your cash flow will be reduced. By projecting the impact your debt load will have on your ability to survive a possible slowdown, cash flow modeling can provide another important warning if you're taking on more debt than is advisable.
- **Receivables Monitoring —** Pay special attention to indicators such as your receivables turnover ratio and days receivable outstanding. When the payment cycle from project owner to general contractor to subcontractor starts to slow down, it can be a sign that business in general is starting to slow.
- **Customer and Project Mix —** Contractors and subcontractors naturally seek to cultivate good relationships with large customers, but it's wise to avoid becoming too dependent on just one or two sources of revenue. Similarly, it can be tempting to leap at the chance to take on a large new project, but be sure you have the financial wherewithal to handle the job without drawing too heavily on your credit lines.
- **Competitive Bidding Pressures —** When things are booming, competitive pressures ease as project owners and general contractors focus on just getting the job done. Conversely, if project owners start becoming more price conscious, or when general contractors start asking subcontractors to bid on work that once was theirs for the asking, this can be another early indicator that business is slowing.
- **Profit Margins —** Shrinking profit margins are perhaps the most widely recognized warning sign of all. Compare financial statements from quarter to quarter and monitor the trend in profit margins closely. When margins start to get squeezed it's time to be extra cautious.

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Employee Compensation

Recruiting and Retaining Key Personnel

With the construction economy recovering, the need for experienced project managers and supervisors is increasing. Unfortunately, the last downturn drove many experienced professionals out of the industry, so qualified senior project management resources are in limited supply.

How can you attract, recruit and retain proven performers? A strong and competitive compensation package is essential. By applying some fundamental principles, you can update your compensation to compete more effectively for the experienced managers and supervisors you need.

A Solid Foundation

Begin with the basics — a solid foundation of salary and benefits, which are guaranteed to the recipient regardless of company or individual performance.

Deciding how much base salary to offer is a judgment call, of course. Salary surveys by local trade groups and employment services, coupled with a bit of online research, can help you determine the general range you should expect to pay for a specific specialty or skill.

In addition to a competitive salary, most managers will also expect a package of traditional benefits such as health and retirement plans. The Affordable Care Act changed the healthcare environment considerably, but health benefits remain a fundamental expectation. The use of a company vehicle is also a popular sweetener that can make a package more attractive.

Incentive Pay

Over and above the base package are incentives that reward project managers or supervisors for specific achievements and allow them to share in the company's success.

Some managers may be attracted by the opportunity to eventually acquire an ownership interest in the business through stock options or other equity offerings. Phantom stock plans and stock appreciation rights can also help keep employees' personal goals aligned with those of the company.

On the other hand, some younger managers might find such programs less appealing and would prefer a more straightforward bonus or performance-based pay system instead.

It is crucial that you understand how your incentive program will operate under varying economic and job conditions before you unveil it to employees.

In the smallest contracting firms, a bonus program may be completely discretionary and informal. Once a contractor grows beyond a few employees, however, there is generally a need for a more structured program that is tangible, transparent and demonstrably objective.

Company and Individual Performance

Generally speaking, an incentive program should be designed with two main factors in mind. First, it should reflect the company's success and reward key employees who made that success possible. Second, it should recognize individual effort and incentivize certain behaviors. Ideally, the program will take both factors into account.

If incentives are based solely on the company's performance — like a straightforward profit-sharing plan, for example — eligible employees may perceive that their bonuses are being diminished by factors they cannot control, such as high executive salaries or ownership perks that drive down the bottom line.

Conversely, if bonuses are based solely on individual or project performance, the company could find itself committed to paying bonuses to successful project managers even if the company is actually losing money overall.

In most cases, the solution is a blended plan triggered by some broad company measure, such as gross margins above a specified level. Once the bonus pool is established, it is then allocated based on individual or project-based performance metrics.

These metrics should be carefully considered so that they encourage specific behaviors that are beneficial to the company overall. The program should also be adaptable to reflect individual circumstances or unexpected complications.

For example, if a project runs into trouble, it makes sense to put your best project manager in charge to turn it around. But if bonuses are based solely on a project's bottom line, your best performer could be penalized for taking on the challenge.

Test Before You Commit

When designing a compensation package, begin by analyzing the makeup of your company, the nature of the people who will be participating, and the types of jobs your company performs. A contractor that handles just a few large projects at a time will need a program that's very different from one that performs several hundred small jobs every year.

Finally, take some time to run financial models of your program under various scenarios. This will require support from your accountant, but it is crucial that you understand how your incentive program will operate under varying economic and job conditions before you unveil it to employees. ■

Our firm can help you analyze your employee compensation and incentive programs. Please call us to learn more.

Growth Strategies

Things to Consider When Evaluating an Acquisition

Analysts tell us the construction industry has been experiencing strong merger and acquisition (M&A) activity in the past year or so. According to one study, 2014 saw more than 218 major deals (deals worth more than $50 million) in the construction and engineering sectors worldwide. That was a 25 percent increase from the previous year.

Such global macroeconomic trends may not immediately manifest themselves at the local level. Nevertheless, construction companies that are looking to jumpstart their growth plans might want to consider the possibility of a strategic acquisition.

Why Consider a Merger or Acquisition?

In addition to sparking the growth cycle, a merger or acquisition could help your contracting firm diversify into new types of work that are similar or complementary to your current project mix. An acquisition can also help you gain a foothold in a neighboring geographic market.

Your firm might also be interested in taking on another contractor's workforce, especially if those employees have specialized skills or expertise in areas that are currently in high demand. A strong backlog and ongoing connections with recurring customers can also make a contractor an attractive acquisition target.

Vertical integration can also offer opportunities. For example, acquiring a major vendor or a supplier can help you control costs and ensure a steady supply of essential materials. At the same time, though, be aware of the new management skills and experience that will be needed if you expand beyond your firm's area of expertise.

Evaluating a Potential Acquisition

Private equity groups and other serial acquirers have in-house experts and well-developed systems for conducting due diligence, valuation, post-deal accounting and other specialized processes that are involved in an acquisition. For a contractor that is considering a single transaction, many of these specialties will need to be outsourced.

Valuation of assets can be particularly challenging. Even relatively straightforward steps such as equipment appraisals can require specialized expertise in order to accurately factor in the equipment's age, depreciation, condition and expected useful life.

Paper assets, such as current backlog and receivables, present many valuation challenges. For example, contracts in progress must be carefully reviewed to see that estimates were sound, projected margins are realistic and receivables are in fact collectible. Less tangible assets, such as customer contacts and contractor reputation, can be even more difficult to value.

The final valuation will likely be compared to some general rule of thumb such as 1-to-3 times cash flow, or perhaps 3-to-4 times adjusted earnings before interest, taxes, depreciation and amortization (EBITDA). But this is only a starting point. Adjustments must be made to take into account any practices that are outside industry norms, such as unusually high executive salaries or benefits, as well as the value of any equipment being acquired.

Avoiding Common Pitfalls

As a buyer, you will most likely want to structure the deal as a purchase of assets only, rather than a total stock acquisition. This can be an area of serious contention, however, since most sellers generally prefer a "clean" stock acquisition due to the tax advantages such a transaction offers.

From a buyer's perspective, a total stock acquisition exposes the company to many additional risks, such as possible environmental issues and warranty liabilities. It may be necessary to purchase some form of "tail" insurance to provide coverage for issues that arise after the sale.

You should also be careful not to buy assets that could bring down your firm's bonding capacity. Talk to your surety about how an acquisition target's existing contracts could affect your ability to get bonding for additional projects.

Finally, of course, be sure to consult with your legal, banking and accounting professionals before closing the deal. Their objective analysis can help you more accurately assess the pros and cons. ■

Our firm can help you evaluate a potential acquisition or other growth opportunity. Please call us for more information.

Boom or Bust?

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Don't Get Distracted

As memories of the last recession begin to fade, it's easy to get distracted from the need to pay close attention to financial indicators. The natural tendency is to focus on gearing up for more work and seeking out additional opportunities.

But a steady flow of business actually makes it even more important to monitor financials closely. Strong cash flows and a growing backlog can give you the leverage you need to prepare for the next slowdown. ■

Do you have questions about key business indicators? We can help you find the answers. Please call us for an appointment.

IN 1944, Thomas Saltmarsh, Harold Cleaveland and Charles Gund pooled their talents and modest resources to form a partnership for the practice of accounting. The three founding partners soon established a client base that included large and small businesses, as well as commercial and governmental accounts. Their success was attributed to their guiding principles of honesty and integrity, accuracy and thoroughness, quality client service and, most importantly, the belief that service to the community is an individual as well as a corporate, responsibility.

TODAY, Saltmarsh offers a variety of services — from accounting and taxation to consulting — all based on the Firm's mission statement and core values. It is this philosophy, based on the principles of yesterday, that has helped the Firm grow to one of the largest locally-owned certified public accounting firms in the Southeast.

SALTMARSH CONSTRUCTION ADVISORS are here to meet the specific needs of contractors, home builders and related trades within the construction, real estate and development industries. Because we truly understand construction accounting and financial management, contractors and developers of all sizes and different trades rely upon our experience. Need assistance? Contact the construction advisors at Saltmarsh or call us today at 800.477.7458.

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Data Security — It's Not Just an IT Problem

Your IT systems house a wealth of sensitive information. In addition to your own proprietary financial records, business plans and competitive strategies, you also maintain confidential employee financial and health information, as well as your customers' project plans and specifications.

When it comes to protecting this data, there's much we can learn from the recent high-profile attacks on retailers, healthcare providers and government agencies. Those attacks show that even the most sophisticated IT systems are vulnerable — there is no such thing as perfect security. So you must be prepared to deal with the aftermath if your security systems are compromised.

This means developing a detailed incident response plan, with designated responsibilities and a step-by-step plan of action for securing and recovering lost or stolen data. Every contractor should also maintain adequate off-site or cloud-based backup systems to help recover from a "ransomware" attack or other incidents that can make data inaccessible.

While it is natural to turn to technology to protect data, it's also important to recognize that data security is not solely a technical problem. In fact, it is fundamentally a people problem.

Remote hackers are a threat, and your firm certainly should install up-to-date security software. But there is a much greater likelihood that sensitive data will be compromised by the actions of an employee. It could be a disgruntled employee who leaves with proprietary information, or a well-intentioned employee who simply uploads data onto an unsecured device or cloud server so it can be accessed remotely.

In today's interconnected work environment, it's essential that all employees with access to data receive regular training on data security best practices. They should be especially alert to phishing schemes designed to trick them into revealing passwords or otherwise compromising system security. ■

Please call us if you have questions about securing financial data and other information.