ON-SITE

Spring 2014

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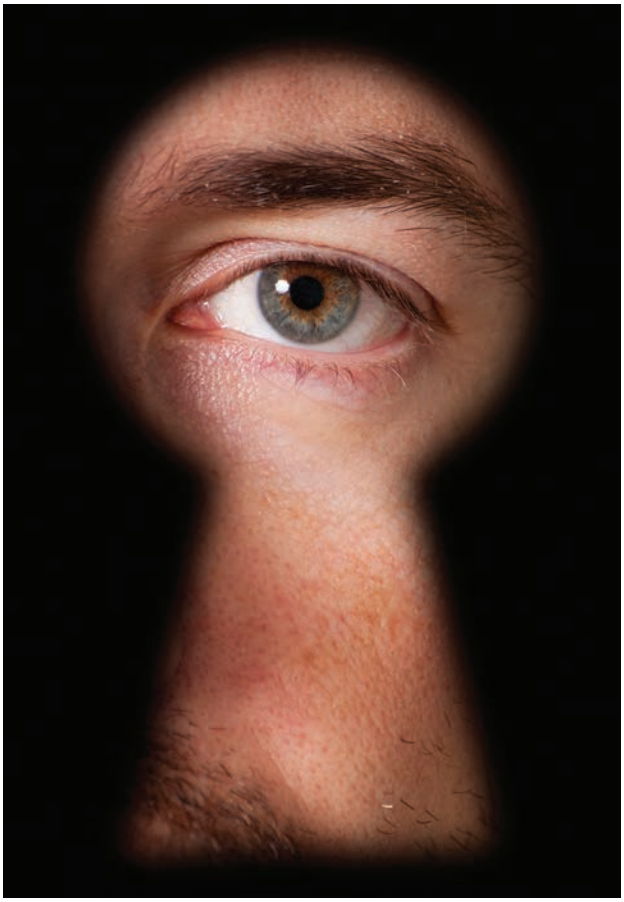
Operational visibility for construction companies

Many construction business owners fall prey to "keyhole vision." That is, you're trying to envision your company's future but limiting your viewpoint to the size of a keyhole. Contractors who want to grow their companies need to step back from that keyhole and knock down the door. A concept called "operational visibility" can help you do just that.

3 areas of awareness

Operational visibility refers to maintaining regular attentiveness to every major aspect of your business. For contractors, that means paying close attention to three primary areas:

1. Current and pending projects. Your job sites truly are the front lines of your operations. So,



ideally, you need quick access to a dashboard that delivers regularly updated key performance indicators (KPIs) for each job.

For jobs underway, these should include labor productivity, schedule variance, budget variance, unapproved change requests and cash flow. For upcoming work, critical KPIs include your total work backlog and committed costs.

2. The office. Back at home base, there are a wide variety of financial KPIs that can help you stand guard against a crippling cash-flow crunch or out-of-control debt.

Four particularly important examples are your debt-to-equity ratio, gross profit margin, average age of accounts receivable and working capital ratio. If you haven't done so lately, ask your financial advisor to go over these and other KPIs and, again, set up a means of monitoring them on a daily or weekly basis.

3. The economy … and beyond. Total operational visibility also involves staying apprised of external factors that affect your company. For instance, the local, state and national economy plays a huge role in the size and availability of construction projects. Politics play a role, too. How will elections on every level of government affect laws and regulations that pertain to the construction business?

And, as always, there's technology. Innovations here could allow you to work more effectively and efficiently — or permit your competitors to do so if you ignore technological changes.

Report generation

It's critical to have monitoring systems in place to track chosen KPIs and other measures every

day. But the data you gather also warrants deeper examination that can only come from report generation.

For job site information, this means field reports. These should generally include the project-specific KPIs mentioned above as well as other job-costing data. They can also include job-progress narratives by project managers with notes about labor productivity. A side benefit of field reports is that, in some cases, you may be able to use them to prevent or fight claims by demonstrating that work was performed in good faith.

Office-generated information should ultimately end up in your financial statements. Some newer or very small construction businesses tend to undervalue these documents. A small percentage of companies don't even keep them. That's a big mistake. Your financial statements contain an incredible amount of information that can help you better understand your financial position.

How you track and report economic, political and technological issues is up to you. Consider delegating this task to a manager and having him or her present updates at monthly or quarterly meetings.

Analysis and prediction

So once you have all of this data, and you're generating all of these reports, what's next? The third major aspect of operational awareness is analysis and prediction.

It's here that many contractors hit a wall. Information overload is a way of life in today's business world, and the construction industry is no exception. You want to analyze everything, but too quickly find yourself overwhelmed.

This is where having well-defined strategic objectives comes into play. In short, to succeed at operational visibility, you must know precisely how you're going to grow your business. Common and perhaps worthy goals include:

- Increasing top-line revenue,
- Improving labor productivity, and
- Expanding into a new market.

Additionally, you can use knowledge gained through operational visibility efforts for *predictive* purposes. That means spotting industry trends, forecasting budgets and steering clear of cash-flow choke points *before* your business runs aground.

Right there

Operational visibility simply means taking the time to step back and see the big picture. Easier said than done, of course. But the good news is that everything you need to be able to look up from that keyhole and kick down that door is right there in front of you. ☒

Wearable tech: Where operational visibility goes literal

The term "operational visibility" (see main article) is conceptual. If you're interested in taking it literally, however, another term to familiarize yourself with is "wearable tech." It refers to hardware that can be affixed to clothing or headgear to record video or provide "augmented reality" data such as building specs or job-costing figures.

In a construction context, wearable tech offers the possibility of actually viewing your operations in action. Wearable cameras, for example, can be placed on the hardhats of project managers as they tour job sites. From the home office or trailer, you can then see real-time footage of work being done and hear, first hand, conversations with laborers and other on-site parties. This capability is a natural evolution from webcams, which have limited to zero mobility.

Police forces and the military have already pioneered field usage of wearable tech. And the technology is now slowly integrating itself into construction. There would be a notable financial cost and learning curve to implementing it. But if you're looking for a way to get on the cutting edge, try this on.

Preparing for an audit while you "think taxes"

Come springtime, many people start to "think taxes." While doing so, contractors might also want to think about how to best position their construction business to minimize the chances of a time- and resources-consuming IRS audit.

Accounting method disputes

Many contractors prefer cash accounting to accrual accounting, which can be more complex and sometimes require you to pay taxes on income you haven't yet received. The IRS, on the other hand, isn't a big fan of cash accounting because it can delay tax payments.

Generally, the IRS allows contractors with less than $10 million in annual sales to use the cash method. But the accrual method is required for C corporations (and partnerships involving a C corporation) with more than $5 million in annual sales. Pass-through entities, such as S corporations and limited liability companies (LLCs), can typically use the cash method unless they have a long-term contract, in which case they need to use the percentage-of-completion method.

Even if you aren't required to use the accrual method, be aware that using the cash method may invite IRS scrutiny.

For contractors who spend generally 10% to 15% of their gross income on substantial purchases of materials, such as inventory, the accrual method is also required — even if annual sales are less than the otherwise applicable $5 million or $10 million threshold. Inventory items need to be monitored and capitalized unless paid for and consumed immediately.

If you're audited and you've been using the cash method when you should have been using the accrual method, you may be forced to postpone deductions and pay penalties. Even if you aren't required to use the accrual method, be aware that using the cash method may invite IRS scrutiny.

Employee misclassification

Independent contractors are a big part of the construction industry. But if your business uses them, proceed with caution. The IRS has long believed that a significant percentage of employers misclassify employees as independent contractors, potentially costing the federal government millions of dollars in, among other things, payroll and income taxes.

Although the IRS does now offer the Voluntary Classification Settlement Program (VCSP) to help resolve disputes in this area, it's shown no signs of letting up on investigating employers for misclassification. To avoid becoming a target, make sure

your workers meet the criteria for independent contractors and that you issue 1099 forms to them.

Long-term contracts

As you may know, contracts that span over two calendar years are considered long-term. What you may not know is that the IRS watches these carefully to make sure contractors pay their taxes on the monies involved in a timely manner.

Many long-term contracts are subject to the percentage-of-completion method, which requires contractors to pay taxes each year on the portion of the contracts that were finished in that year. Some smaller contractors are allowed to use the completed-contract method, though, which lets them put off paying taxes until projects are done.

If you're using the completed-contract method, keep in mind that the IRS may look into such contracts to make sure you're not unnecessarily dragging out the terms. A couple of potential audit triggers: 1) a delay in completion of a contract that's almost done to the next tax year, and 2) a contract that contains separate projects that could be treated as separate contracts, such as identical apartment units.

Business structure

In the past, structuring a construction company as an S corporation was generally believed to be a more effective audit shield than operating as a sole proprietorship or even a single-member LLC.

But times have changed. In November 2013, the head of the IRS Small Business/Self-Employed Division issued a statement declaring the agency's intention to make auditing pass-through entities a top priority in 2014 and beyond.

Because of the administrative and legal complexities involved, you probably shouldn't change your business structure just to minimize IRS scrutiny. But it's a factor worth considering.

Specific concerns

This article isn't an exhaustive list of every situation or dispute that could trigger an IRS audit. Work with your tax advisor to address concerns specific to your construction company. ☒

More than money: Customer-smart invoicing

It's simple, right? You send customers an invoice and they pay up. But the process can be so much more — it can be an opportunity to improve business relationships and gather useful data. It's called "customer-smart invoicing," and it's about more than just money.

What's the problem?

Ask contractors why they're not getting paid and many might say, "They don't have the money!" Just last year, postsale relationship consultants TermSync surveyed businesses about delayed payments. Some 49% of respondents blamed purchase order (PO) miscommunications as the top reason for tardy accounts receivable. Insufficient funds did come in second, but at a much lower 27% of respondents.

This is actually good news. You can't do much about your customers' cash flows. And, in the "paid when paid" environment of the construction industry, payments will likely always be challenging. But you can improve the invoicing discrepancies that could be causing payers to set your bills aside to call about later — much later.

How well do you communicate?

Customer-smart invoicing is broadly based on two concepts: communication and information. Let's start with the former, for which your objective is to prevent the PO perplexity mentioned in the survey above.

Start looking at invoices as *opportunities* to reach out to customers and initiate positive interactions. For example, several days after sending out invoices, you might dispatch follow-up e-mails expressing gratitude for the business, requesting confirmation receipts and asking whether anything is unclear.

For high-importance customers, you could get your sales staff in on the process. Have them make phone calls — not to demand payment, of course, but just to ensure the invoice got there and to clarify any confusion as to its terms.

Are you learning anything?

The second major aspect of customer-smart invoicing is information. Or perhaps a better word might be "education." By tracking a few key metrics, your invoices can teach you invaluable things. Such metrics include:

1. Time to payment. The time from the date you remit an invoice until you have the check in your hands should, obviously, be as short as possible. But it's important to track trends to make sure payment times aren't dragging out of control.

2. Accuracy of invoicing. Total the number of invoices you've sent out over a given period (say, six months or a year) and then compare it to the number of customer questions or disputes. (You'll need to start tracking those, too.) The resulting ratio should be as far apart as possible — if you're creeping toward 1:1, something is definitely wrong!

By tracking a few key metrics, your invoices can teach you invaluable things.

3. Time to resolution. As you track customer invoice inquiries and disputes, record the date of the very first interaction and the date of resolution. If it's taking many days or even weeks to resolve problems, you'll know (at least partly) why your collections and cash flow are suffering.

4. Customer satisfaction. Gathering this information can be as simple as asking customers to fill out a brief (three to five questions) "on a scale of 1 to 10" survey about their experience with your construction company. You can include this as a postage-paid card in paper invoices or as a hyperlink included in e-mailed or online invoices.

Where to begin?

Adapting to customer-smart invoicing doesn't necessarily mean overhauling your entire system. To begin with, identify the areas that need improvement and then decide whether better customer communication or gathering more information could serve you well. ☒

The Contractor's Corner

How can I get my technology in order?

I've always kept an open mind to technology. But over the last five years, so much has changed. Sales and estimating staff are using this smartphone app; accounting is using that software; project managers are sharing documents in the "cloud." I feel like I've lost control and could be at risk for losing data or wasting money. Any suggestions?

If it makes you feel any better, you're not alone. According to the *2013 Construction Technology Integration Survey* conducted by consultants JB Knowledge Technologies Inc., 82.8% of responding contractors agreed that software integration is important. Yet more than a quarter of respondents — 28.3% to be exact — haven't integrated all of their software.

Short of tearing everything down and starting from scratch, there's probably little you can do immediately. Over the long term, however, you could implement a companywide strategic IT plan.

Setting objectives

The objective of a strategic IT plan is to, over a stated period, roll out consistent, integrated and secure hardware and software. In doing so, you'll likely eliminate many of the security dangers wrought by lack of integration, while streamlining data-processing efficiency.

To get started, define your IT objectives. Identify not only the weaknesses of your current infrastructure, but also opportunities to improve it. Employee feedback is key: Find out who's using what and why it works for them.

From a financial perspective, estimate a reasonable return on investment that includes a payback timetable for technology expenditures. Be sure your projections factor in both:

- Hard savings, such as eliminating multiple job-costing apps, and
- Soft benefits, such as being able to more quickly and accurately transmit data from job site to office.

Also calculate the price of doing nothing. Describe the risks and potential costs of falling behind or failing to get ahead of competitors technologically.

Working in phases

When you're ready to implement your strategic IT plan, there's some good news: It can look familiar. That is, just like a construction project, you can take a phased approach to adopting technology. Perhaps lay the foundation with a new server and then install consistent, integrated applications on top of it.

A phased implementation can also help you stay within budget. You'll need to have a good idea of how much the total project will cost. But you can still allow flexibility for making *measured* progress without putting your cash flow at risk.

Considering a roof

There's nothing wrong or unusual about wandering the vast landscape of today's endless technological changes. But, at some point, every construction company should at least consider bringing all their bits and bytes under one roof. ☒