

TOP CONTRACTORS

Actively Manage Operational Performance

BY SUZANNE VERITY

ven when tested by tough economic times, top-performing general contractors and subcontractors focus on measuring financial performance and adjusting their operational practices.

conclusions are based on a comparison between those that placed their company in the top quartile (top performers) against those that placed their company in the bottom two quartiles (underperformers)

About 240 contractors provided insight into their operational practices by participating in the inaugural ProfitCrew *Best Practices for Operational Excellence* survey, co-sponsored by Clemson University and *Construction Executive*.

“The results of this survey tell the story: It takes a close eye on all elements to make a successful business,” says Michelle DeGordon, senior manager with Bober Markey Fedorovich, Akron, Ohio. “Our experience has proven that contractors are usually very good at managing the work and perfecting their craft. However, they usually fall short when it comes to managing the business, and this makes all the difference.”

This is the first recession many construction company owners have experienced. “Many of our new construction clients are somewhat unaware of just what types of things they need to be doing internally to better manage their business,” says Jay P. Rammes, CPA and director at Barnes Dennig, Cincinnati. “This survey and its results create a roadmap for underperforming contractors to take action.”

To determine the top performers, respondents were asked to estimate the group into which they fall based on several performance metrics. The following



**STUDY REVEALS SUCCESSFUL
BUSINESS' BEST PRACTICES**

with respect to percentage of pretax profit. Following are the best practices of top performing contractors revealed in the study.

ANALYZE PERFORMANCE

Regularly preparing and reviewing financial reports is a clear best practice for general contractors and subcontractors.

“In good times and in challenging times, top-performing contractors pay attention to the details, utilizing best practices and drawing on wisdom gained from past experiences,” says David Thompson, CPA and partner with Hutchinson & Bloodgood LLP in San Diego.

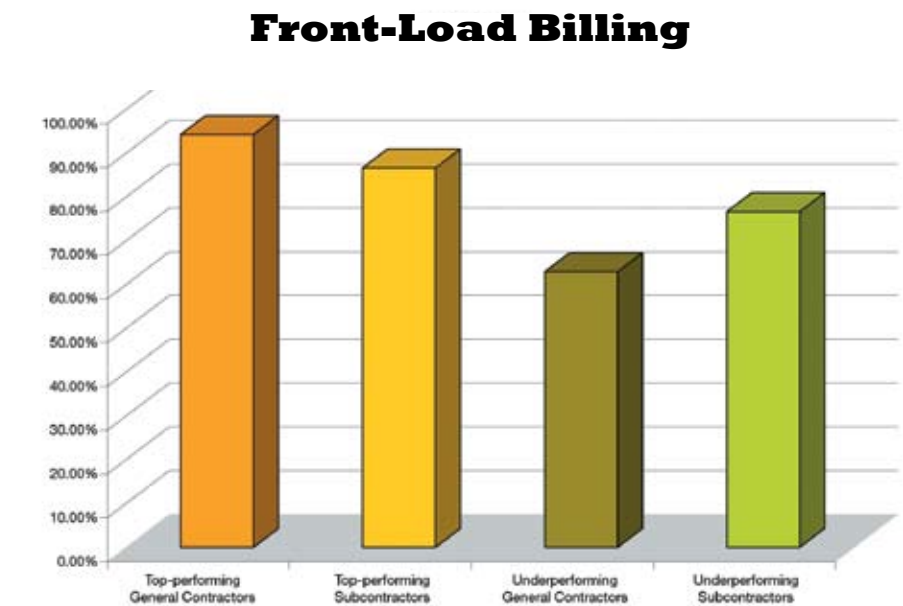
Frequent and accurate financial data is essential to understanding what worked and what didn't. Top-performing subcontractors are more likely to prepare internal financial statements on a monthly basis (77 percent of top performers versus 47 percent of underperformers). Also, more than 61 percent of top-performing subcontractors review peer benchmarks at least annually, versus 41 percent of underperforming subcontractors.

Among general contractors, top performers are more likely than underperformers to prepare ratio analysis reports on at least an annual basis (91 percent of top-performing general contractors versus 59 percent of underperforming general contractors).

Who reviews these reports is as important as how often they are reviewed. In the study, the top-performing subcontractors were more likely than underperforming subcontractors to:

- have someone in senior management (e.g., a CEO, CFO or department head) review peer benchmarking, ratio analysis, financial forecasts and cash flow reports;
- have project managers or field supervisors review receivables aging reports, work in progress and budgeted versus actual job cost reports; and
- submit most performance analysis reports to an outside financial advisor (e.g., surety, bank or accountant).

“Every set of financial statements tells a story, and it's important to know what that story is telling your bank and surety,” says David McLellan, CA and partner with Catalyst LLP, Calgary, Alberta. “Many banks and sureties will accept some covenant violations as long as the com-



pany provides a plan to move forward and correct any deficiencies. Showing that you understand your ratios, where you fit in your industry and why these ratios are important gives your lenders and sureties more confidence in you.”

Regular review of these financial reports is essential for a construction company to keep an eye on profitability, cash flow, firm leverage and liquidity. Along with forecasting, these are the four categories into which construction companies' key financial indicators tend to fall, says Dennis Bausman, associate professor in the department of construction science and management at Clemson University.

Nonfinancial indicators, such as IT utilization, employee retention, employee satisfaction and wage progression, are another important source of data that give general contractors insight into their operations and provide perspective to guide future decisions. Top-performing subcontractors are more likely to be concerned with project-specific factors: schedule variance, project safety and skill certification.

PAY ATTENTION TO FINANCIAL MANAGEMENT

Top performers are more aggressive in billing—and getting more of their cash upfront. More than 94 percent of the best general contractors report they front-load billing on at least some jobs, compared to about 62 percent of underperforming general contractors. The distinction is not as dramatic with subcontractors: 87 percent of top performers front-load bills

on some jobs, versus 77 percent of underperformers.

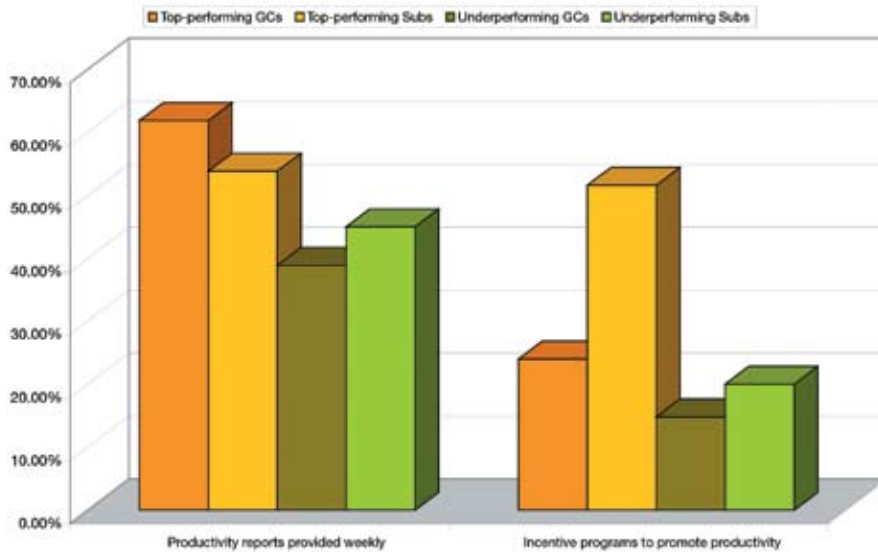
“My experience has been that successful contractors, even when the market has tightened, tend to pay close attention to cash flow, knowing what their overhead costs are, and building equity in order to establish a firm foundation to weather challenging times,” Thompson says.

Paying close attention to indirect costs is another best practice that can make a huge difference for contractors dealing with razor-thin margins.

Top-performing general contractors and subcontractors are more likely to allocate indirect costs in accordance with guidelines from the American Institute of CPAs. These guidelines state that contractors can use a percentage of direct labor costs, direct labor hours, or a combination of direct labor and material costs when allocating indirect costs to contracts. More than 70 percent of top-performing subcontractors and almost 60 percent of top-performing general contractors follow these guidelines; around 30 percent of the underperformers in both categories follow these.

Tracking and updating these indirect cost factors is an important key to job profitability, says Chip Dillman, senior audit manager with Charlotte, N.C.-based Greer & Walker LLP. “Contractors that don't allocate indirect costs to projects, or improperly allocate them, aren't getting an accurate picture of the profitability of each job,” Dillman says. “This can lead to underbidding and, ultimately, the failure

Monitor Productivity



of the company.”

MONITOR PRODUCTIVITY

Top-performing contractors provide productivity reports to project managers at least monthly. Among general contractors, more than 60 percent of top performers provide these updates at least weekly, compared with 39 percent of underperformers.

“Project managers should be provided with weekly productivity reports in order to manage the job as effectively and efficiently as possible,” says Laurie Johnson, CPA and partner with Johnson Jacobson Wilcox, Las Vegas. “In addition, job analyses should be performed to determine which estimators, project managers and types of contracts are most profitable.”

By staying abreast of their productivity, top performers are better able to estimate the true costs of a potential project, says Vito Loisi, CPA and partner with Wolf & Company LLP, Oak Brook, Ill. “The top-performing companies do not take unprofitable projects because they understand their cost structure,” he says. “Some people take an unprofitable job and try to make it up by being more efficient than the bid, and you just can’t do it.”

There is still considerable room for improvement in the area of monitoring productivity. About 50 percent of top-performing subcontractors have employee incentive programs, compared to just 20 percent of underperformers. But among general contractors, only 24 percent of top performers and 15 percent of underper-

formers have incentive programs.

Contractors also are generally missing out on the opportunity to conduct post-project reviews, although top performers are more likely to hold these debriefing meetings on a regular basis. About 30 percent of top-performing general contractors and 23 percent of top-performing subcontractors hold review meetings after every project, versus 19 percent of underperforming general contractors and 13 percent of underperforming subcontractors.

Contractors that perform post-project reviews not only experience fewer problems on subsequent similar projects, but they also realize a savings in direct and indirect costs, says Roger Liska, pro-

fessor and chair of the department of construction science and management at Clemson University. But Liska is not surprised by the relatively low percentage of respondents that perform post-project reviews and provide incentives to encourage productivity.

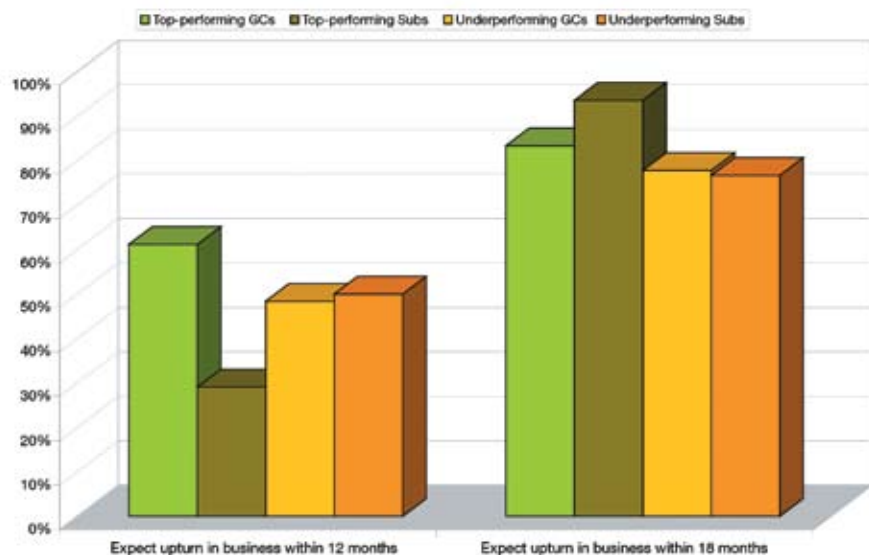
“These percentages (below 50 percent in most cases) are typical of our industry and reflect either or both of the following: Contractors do not see the benefits in doing these things, and those that do (generally larger construction companies) see them as taking away from their profit instead of as an investment to improve their profits. Or, contractors do not know how to conduct post-project reviews or effectively provide incentives for productivity improvement,” Liska says.

HAVE AN OPTIMISTIC OUTLOOK

While few contractors foresee significant growth in the near future, top performers generally have a rosier outlook. More than half of top-performing subcontractors expected 2009 revenue to stay flat or increase, whereas about one-third of underperformers expected flat or positive growth.

While general contractors are more conservative—more than 68 percent of top performers expect a decline in revenues in 2009—they do see light at the end of the tunnel. More than 60 percent of top-performing general contractors expect an upturn in business within 12 months, versus 44 percent of underperformers.

Economic Outlook



Subcontractors generally expect an upturn within 18 months, although 23 percent of underperformers think it will take longer.

This optimism seems to be founded in reality: At the time of the survey (March through June 2009), more than 60 percent of top-performing subcontractors had at least five months of backlog, versus 34 percent of underperformers with the same amount. Among general contractors, 52 percent of top performers had at least five months of backlog, versus one-third of underperformers.

According to Associated Builders and Contractors' new Construction Backlog Indicator, the average backlog for nonresidential contractors during May 2009 was 6.3 months.

Contractors indicated that several factors are impacting their expectations for growth in 2009. Top-performing general contractors are significantly more likely than underperforming general contractors to expect materials costs and availability of bonding to positively affect growth; top-performing subcontractors are significantly more likely than underperforming subcontractors to expect availability of bonding and employee retention to positively affect

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growth.

Top-performing general contractors are significantly less likely than underperforming general contractors to expect the inability to collect receivables to negatively affect growth, and top-performing subcontractors are significantly less likely than their underperforming counterparts to say that customer demand and employee benefits costs will negatively affect growth.

The results of the ProfitCrew *Best Practices for Operational Excellence* survey indicate contractors that actively manage their businesses are more likely to see positive growth and profitability during poor economic conditions.

“The most important takeaway from this survey is that poor performers are only tending to the work at hand and paying little attention to running the business,” DeGordon says. “Top performers are concerned with factors such as employee performance and retention, utilizing technology, aggressively billing and managing receivables, performing ratio analyses and conducting post-project reviews.”

Most importantly, contractors should stay optimistic. “Housing starts are on the rise and economists are predicting an upturn in the economy by early 2010,” says Adam Polakov, CPA and manager and real estate/construction practice leader with Porter Keadle Moore LLP, Atlanta.

“Talk to your CPAs about targeted tax incentives for the construction industry. But, most importantly, schedule regular meetings with your lenders and surety agents to keep them in the loop. Don't surprise them with bad news late in the game,” Polakov says.

Suzanne Verity is president of ProfitCrew, an association of accountants and consultants. For more information or to request a copy of the complete survey report, email sverity@profitcrew.com.



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The construction business is like no other, with cycles and risks all its own. It's even one-of-a-kind when it comes to accounting, taxes, key performance indicators and profit drivers. That's why general-practice accounting firms don't have a thorough understanding of your toughest challenges – or your best opportunities. ProfitCrew™ is a dynamic group of accounting firms who know construction and real estate. We have a deep level of industry-specific expertise and are dedicated to solving your real-life accounting, tax and business problems.

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