

# CONTRACTOR

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**Plus!**

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## Nasty numbers

8 red flags to watch out for  
in your financial statements



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# Nasty numbers

## 8 red flags to watch out for in your financial statements

**F**inancial statements show not only where a construction company is financially, but also where it's going. Contractors who work with their financial advisors to analyze their statements can often catch problems early on — before they turn into bigger issues. Here are eight red flags to look out for when reading your next statement.

### 1. An accumulation of cash (or lack thereof).

A strong cash flow is one of the hallmarks of a successful business. But the key word here is *flow*. A growing but static reserve of cash can be a sign that your backlog is dwindling and you're running out of work, leading to a stockpile in the cash column.

On the other hand, if you find yourself drawing on a line of credit when payments for a given



project are slow in coming, you could also be headed for trouble. A construction company should always be in an overbilling position on a job. If underbilling is occurring, ask your financial advisor to perform an over/under billings analysis to get a handle on this dilemma.

**A construction company should always be in an overbilling position on a job.**

**2. Declining equipment value.** Slow periods in your business can lead to an unnoticed decrease in your equipment's value and force greater spending down the line. You may be tempted to think that, because your assets aren't getting as much wear and tear, they're maintaining their value.

But, just as it does for a new car driven off the lot, annual depreciation continues to steadily do its work on your assets. Plus, you're not buying replacement equipment at current market prices, meaning you'll likely pay more when you finally have to upgrade.

**3. Significant liability changes.** Substantially changing liabilities warrant a close look. If your profits are dwindling, for example, certain liabilities may shrink as well, such as payments to profit-sharing plans or deferred tax liabilities.

On the other hand, liabilities can balloon if you take out a loan to keep your construction business afloat. Having a large amount of unsecured debt is a particularly bad sign for any company.

**4. More current liabilities than current assets.** Because many contractors have seasonal swings in their businesses, you may have more bills to

## Key words: A financial statement glossary

If you've been in the construction business awhile, you're likely familiar with most of the key words on your financial statement. Nonetheless, it doesn't hurt to review these terms and think about how they currently apply to your company. Here's a handy financial statement glossary:

**Balance sheet.** This provides a snapshot of a company's assets and liabilities. *Assets* are items of value, including cash, accounts receivable, equipment and intellectual property. *Liabilities* are debts such as accounts payable, payroll and lines of credit. The balance sheet also states the company's net worth, which is calculated by subtracting total liabilities from total assets.

**Cash flow statement.** This shows how much cash a company generates for a particular period, which is a good indicator of how easily it can pay its bills. The statement details the net increase or decrease in cash as a result of operations; investment activities, such as property or equipment sales or purchases; and financing activities, such as taking out or repaying a loan.

**Income statement.** Also known as a profit and loss statement, the income statement shows revenues and expenses for a specified period. Its goal is to depict which parts of the business are profitable, so it matches revenues and expenses carefully for specific projects.

**Retained earnings/equity statement.** This statement shows how much a company's net worth grew during a specified period. If the company is a corporation, the statement details what percentage of profits for that period the company distributed as dividends to its shareholders and what percentage it retained internally.

pay than cash on hand at one time of the year or another. This is something worth tracking and planning around. Also, consistently having more current liabilities than current assets is typically a sign that you're overleveraged.

**5. Shrinking gross profit margin.** Your gross profit margin is equal to your building costs for a particular period — not including overhead, payroll, taxes and interest payments — divided by your sales revenue for the same period.

If this ratio is dwindling, it means your production costs are rising more quickly than your prices, or you're charging less for your construction services (perhaps in an attempt to gain market share). Both trends can sink your business quickly, so track your profit margin closely.

**6. Increasing ratio of general and administrative expenses to profits.** General and administrative expenses, such as rent and utilities, are less "elastic" than project expenses, such as labor and materials. Thus, the ratio of these expenses to your profits will skyrocket if workload sags.

Also keep an eye on indirect costs, such as insurance, that you allocate to each of your contracts. If the amount of these rises significantly, it's often because you have fewer contracts to allocate these expenses to, which could spell financial trouble.

**7. Receivables growing faster than sales.** If your receivables start to dwarf your actual sales, beware. It may be a sign that customers are taking longer to pay their bills — or not paying at all — and that it may be time to revamp your collection procedures.

**8. Far-off or unprofitable future projects.** Although you may take comfort in the sight of a lengthy project backlog on your financial statements, remember that not all projects are created equal.

If you have jobs scheduled in the distant future, but nothing for the next few weeks (or months), start strategizing how to pay your bills immediately. Quality also trumps quantity: A smaller number of profitable jobs may prove more beneficial than a large number of jobs with slim profit margins, or even potential losses. ■

# Implementing an accident prevention and response program

**C**onstruction sites are inherently dangerous places. To protect your workers and bottom line, you must *actively* work at minimizing safety hazards and handling injuries appropriately. Read on for some tips on implementing an effective accident prevention and response program.

## Starting the conversation

The genesis of any good program lies with your people. Form a company safety committee to review all recent occurrences, discuss how to prevent accidents, and put the program into words and action.

**Every worker needs to know to whom and where to go if something goes wrong.**

Talk about whether your crews are following basic steps, such as noting safety hazards and identifying the resources needed if an accident occurs. Because job sites evolve constantly, also make sure you have someone checking in on projects regularly to see whether new job hazards have developed.

## Handling an incident

Your accident prevention and response program should describe a clear process for responding to and reporting incidents. Every worker needs to know to whom and where to go if something goes wrong.

For smaller crews, the foreman can likely handle and report incidents. For larger ones, you might name an on-site safety officer whose sole (or primary) duties are to maintain safety awareness as well as conduct incident response and reporting.

Turning to the “where,” establish a mandatory first-aid area on every job site to treat minor injuries and coordinate incident response. Identify a local medical facility where employees with nonemergency injuries should go, and ensure any such afflicted worker brings a signed treatment authorization form.

In addition, for every job, require a check-in with local first responders about their limitations. For example, how long will it take them to reach your workers if they’re in a high-rise office building?

## Minimizing the fallout

Following an incident, the foreman or safety officer must complete a detailed report describing the accident and naming everyone involved — including witnesses and potentially liable third parties. He or she should also initiate the report



to your workers' compensation insurer. Get this going right away, as delayed reporting can cause your claim costs to soar.

Establish other procedures as well, such as calling the affected worker and his or her physician within 24 hours after the incident. And then stay in touch to discuss the employee's condition, work restrictions and availability, and developments in the claims process.

### Staying safer, stronger

Safety mishaps can reduce productivity, elevate your insurance costs and even make it harder to land new jobs. Unfortunately, it's impossible to completely eliminate the risk of job-site accidents. Nonetheless, having a comprehensive accident prevention and response program can help keep workers safer and your bottom line stronger. ■



## Consider mediation for your next construction dispute

It's going to happen. A construction dispute, that is. You can hope that every job from here on out goes smoothly. But, if you stay in business long enough, it's highly likely you'll encounter a situation with an owner or developer that can't be resolved with a simple chat.

In such situations, lengthy and expensive litigation may seem inevitable — and if not that, a binding arbitration hearing. But there's another alternative to consider: mediation.

### A selected voice

In mediation, a neutral mediator facilitates a settlement that's acceptable to both parties. The mediator meets with the parties in informal joint sessions — and possibly separately — to help them explore relevant facts, issues, positions, needs and options.

A mediator might identify obstacles, point out overlooked issues and develop resolution strategies. The mediator, however, doesn't give legal advice or resolve the dispute. Instead, the parties must attempt to reach a settlement.

The parties to the dispute select the mediator — typically a practicing attorney, retired judge or other professional. Working with a mediator who has experience and expertise in real estate and construction can expedite the process and foster the introduction of options not previously considered.

### Several stages

Typically, the mediator begins with an opening statement, which includes introducing the attendees and reviewing the procedures, ground rules and goals. The parties then make their opening statements, usually describing

their understanding of the dispute, presenting their cases and proffering ideas for resolution.

Next comes the joint discussion in which the mediator speaks with the parties about the information in their opening statements and determines which issues to address. Each party then meets separately to assess the strengths and weaknesses of their respective positions.

**Lawsuits can take months, if not years, while mediation rarely lasts longer than several days.**

At the joint negotiation stage, the mediator reconvenes the parties to negotiate face-to-face. If an agreement can be reached, the parties put it in writing and either sign the document or have their attorneys review it. Such agreements, once entered into, are enforceable as contracts. If no agreement results, the mediator reviews the process and discusses available options, including another mediation session, arbitration or litigation.

#### **Less adversarial**

The mediator takes a neutral stance, so energy is spent collaborating with the other party rather than trying to persuade the mediator. In this way, mediation is less adversarial than either arbitration or litigation.

What's more, lawsuits can take months, if not years, while mediation rarely lasts longer than several days. And parties can speak for themselves, which can lead to creative solutions not possible in an adversarial setting. A mediator's evaluation of the strengths and weaknesses of a case can change perspectives about the odds of winning in court, paving the way for settlement.

Further, mediations are conducted confidentially. Statements and evidence used in mediation generally can't be admitted as evidence in subsequent

litigation, and mediators can't be compelled to testify. Avoiding a courtroom also means parties aren't subject to legal precedents or the rigid structure of litigation. In addition, mediation doesn't involve formal rules of evidence or the question-and-answer format of a trial.

Finally, mediation is often used with the understanding that the parties will move to arbitration if both don't come away from mediation satisfied.

#### **Arbitration Avenue**

Arbitration tends to be less formal than litigation, but it can include discovery and the use of legal standards. Before the arbitration, the parties make stipulations regarding locale, confidentiality, rules of evidence and issues to be considered. Each party then presents evidence, including testimony and arguments, and can cross-examine witnesses.

Unlike in mediation, where the parties themselves reach a consensus, the arbitrator renders a final and typically binding decision. Further, the rules in arbitration can limit damages, restrict the time limits for filing a claim and impede information sharing. Arbitration has one key limitation: Virtually no appeal is possible.

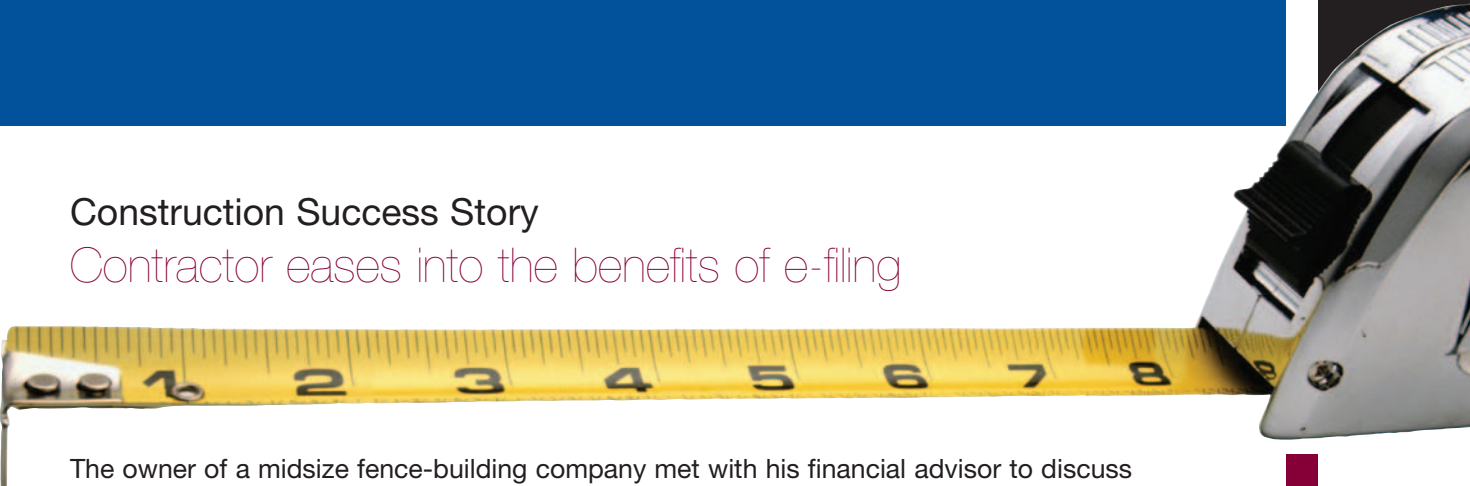
#### **All of your options**

In an industry as wrought with conflicts as construction, it's important to remember all of your options for resolving disputes. Mediation may save you time in the short term and money in the long run. ■



## Construction Success Story

### Contractor eases into the benefits of e-filing



The owner of a midsize fence-building company met with his financial advisor to discuss upgrades to the contractor's accounting system. In particular, he wanted to discuss a recently passed state law that required taxpayers to file forms, as well as pay taxes and fees, electronically. The contractor was used to filling out paper forms and mailing in payments, so he was a little worried about the transition to a paperless method.

It was a concern the advisor had heard before. More governments had begun mandating e-filing as they looked to slash their administrative costs, the advisor explained, and the trend was poised to grow further. Businesses that didn't switch from paper to electronic filing could face fines, and some governments would consider a tax form missing until they received it in the correct format.

#### Fully functional

Because the contractor was already using construction-specific accounting and payroll software, the advisor recommended that he invest in an e-filing application that he could integrate into his existing system.

By doing so, the contractor could direct the e-filing program to pull information already in his accounting and payroll records and fill out many portions of the forms automatically. The system would debit the contractor's bank account to cover needed payments, and the contractor could receive refunds electronically.

The e-filing application would keep track of the contractor's local, state and federal government filing requirements, including income taxes, payroll taxes and new hire forms, the advisor said. It would remind the contractor when deadlines and payment due dates were coming up and even calculate the payments. During income tax season, the advisor could work with the contractor's system to e-file the needed documents.

#### Additional advantages

Along with streamlining his tax filings, the advisor continued, e-filing offered additional advantages. An effective e-filing system would save the contractor time and money spent filling out and mailing forms manually — and increase his filings' accuracy.

Plus, the e-filing service would safeguard against data entry errors by pointing out fields with missing information or data that didn't match the contractor's accounting records. And, by storing forms electronically instead of in a filing cabinet, the contractor also would eliminate the risk of lost, damaged or destroyed forms — and the resulting headaches in the event of an audit.

#### The paperless plunge

After researching various e-filing software products, the contractor chose an application compatible with his accounting software and took the paperless plunge. Although there was obviously an upfront cost and a notable learning curve, it didn't take long before he began to see the benefits his advisor had mentioned coming to fruition. ■

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