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# Directing your attention to indirect costs

Their profitability impact is considerable

**W**ith so much emphasis put on every tiny cost of each and every contract, it's not hard to see why many contractors lose track of their companies' indirect costs. Sometimes referred to as "overhead," these are expenses not directly related to your projects yet necessary for keeping your business running smoothly.

The potential impact of indirect costs is considerable. If you don't stay on top of them, they can creep up on you over time and drag down your profitability.

## Beyond overhead

When we read the word "overhead," many of us understandably envision our physical office space — literally the roof over our heads. But, for a construction company, indirect costs go way beyond that.

For instance, if you pay salaries for activities such as project management, purchasing, contract administration and safety oversight, these likely count as indirect costs. Any fees you incur for real estate appraisals, consulting services

and legal and accounting needs also likely fall in this category. And, of course, don't forget taxes, title transfers, permits, direct costs and some types of insurance.

Costs such as these can have a huge impact on a job. If you neglect to figure them in completely, or at all, surprising cost overruns may result.

*There's no one-size-fits-all approach to tracking and allocating indirect costs.*

## Tax considerations

How indirect costs are treated for tax purposes depends on the nature of a contract and your accounting method. This is one of the prime reasons you need an accurate and trustworthy system for allocating these amounts.

For example, under the federal tax code, contractors must allocate indirect job costs to their long-term contracts every year. If you use the

percentage-of-completion accounting method, you may be able to deduct some allocable indirect costs such as equipment depreciation and workers' compensation insurance. But if you use the completed-contract method, such expenses must be capitalized over the contract's term until completion.

There's no one-size-fits-all approach to tracking and allocating indirect costs. If you've been in business awhile, your established method may serve you well.



But it doesn't hurt to review it periodically to see whether anything is slipping through the cracks and causing you to suffer tax or accounting headaches.

### Assessing the impact

Of course, beyond taxes there lies another question: Are your indirect costs simply too high? You need to know precisely how much indirect costs are affecting you financially, so you can make realistic yet competitive bids.

One way to get a good read on this question is to sit down with your CPA and go over your chart of accounts. It should contain an adequate number of categories to let you see just where your expenses lie.

Plus, your chart of accounts can enable you to set up a budget-to-actual analysis that compares budgeted annual amounts of various expenses with actual costs (both indirect and direct) incurred. The right accounting software can greatly facilitate this exercise.

Another approach is benchmarking. This is a process under which you pick certain metrics — say, a selection of typical indirect costs — and measure them against those of similar construction companies. Trade organizations perform annual surveys that can provide the data you need, or you may be able to engage a construction business consultant to gather the information for you.

Whether it be from an analysis of your chart of accounts or a benchmarking study (or both), when you have the data you need, look to start cutting. Rare is the construction company whose indirect costs are at minimum levels. So define which indirect costs are fixed and which are variable. The latter may be easier to trim.

## Appreciate depreciation-related tax breaks while you can

While you're tracking indirect costs, also consider whether you should buy heavy equipment or other business assets. Why? Because two depreciation-related tax breaks are particularly valuable right now — and scheduled to expire at year end!

First, you may be able to use "bonus" depreciation to deduct an extra percentage on a qualifying asset. This year, that percentage is considerable: You can deduct 100% of the cost of eligible assets acquired and placed in service this year (or by Dec. 31, 2012, for certain long-lived and transportation property). For 2012, the bonus depreciation percentage is scheduled to drop to 50%, though an extension of the full 100% has been proposed. (Check with your tax advisor for the latest information.) Various limitations apply, including one stipulating that the property acquired be new, not used.

Second, there's the tried-and-true Section 179 deduction. It permits you to expense, rather than depreciate, a specified dollar amount of qualified *new or used* asset acquisitions in a given year. For 2011, that amount is also considerable: \$500,000. For 2012, the amount is scheduled to drop to \$125,000 (indexed for inflation). Various limitations also apply here. For instance, the deduction begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed \$2 million (in 2011).

So, if you need to buy some assets in the coming months that would qualify for bonus depreciation or Sec. 179 expensing, there are big tax savings in the offing if you make the purchases this year.

### Attention to detail

You've probably heard the expression, "That's just the cost of doing business." So it goes with indirect costs, which typically arise from things you have to do just to be able to perform your core construction services. On the bright side, with some regular attention to detail, these expenses don't necessarily have to *hurt* your business. ☒

# Don't let workers' compensation costs get the upper hand

**F**or construction company owners, safety is a constant worry. First and foremost, an injury to a worker is a *human* concern that involves the well-being of a person and affects his or her family as well. But there's also a financial aspect — namely, workers' compensation costs.

Skyrocketing premiums and payouts can hurt a construction business during the best of times. But when profit margins are uncomfortably tight, as they've been for many contractors in recent years, a sizable claim (or series of claims) can be devastating. Let's take a look at the key elements of workers' compensation claim management and some ways you can keep these costs from getting the upper hand.

## The power of EMR

Construction companies with strong safety records are rewarded with lower workers' compensation premiums. It all comes down to your experience modification rating (EMR), which is based on your safety record and is calculated by the National Council on Compensation Insurance (NCCI) or, in some states, an independent rating agency.

## *Be aggressive in managing and investigating workers' compensation claims.*

Your EMR is determined by comparing your company's workers' compensation claims to industry average losses in other construction companies of similar size. If you're at the industry average,

your EMR is 1.0. If your workers' compensation claims history is 20% better than average, your EMR would be 0.80.

On the other hand, if your claims history is 20% worse than average, your EMR would be 1.20. And, if so, you could pay as much as 20% more in workers' compensation premiums than a company with an EMR of 1.0 would, according to the Safety Management Group.

An EMR calculation gives more weight to the frequency of injuries but doesn't overly penalize a company for the severity of one particular claim. Put another way, a history of small, recurring claims can affect your premiums more than one large claim, because it shows there may be an ongoing problem that isn't being addressed. So reducing the number of claims will improve your EMR.





## Classification codes

As the risk of injury associated with construction positions increases, so do workers' compensation premiums. Lower-risk jobs, such as clerical work and estimating, have lower injury rates than do hazardous ones, such as roofing. The NCCI assigns classification codes to every job type.

Re-evaluating your classification codes can result in significant savings. First determine whether your employees qualify for the lowest rates for the types of work they do; then try to reduce the number of employees whose jobs warrant higher classification rates.

## Basic measures

The most obvious way to reduce workers' compensation costs is to create a safer work environment on job sites and in the office. This not only will reduce your EMR and, thus, your premiums, but also help ensure the long-term health of your employees.

To that end, insist that employees keep job sites clean and orderly, and require workers to wear appropriate protective gear at all times. Provide

regular safety training classes and consider giving bonuses to employees who reach measurable safety goals. Welcome suggestions from employees about how to make job sites safer for all.

Be aggressive in managing and investigating workers' compensation claims. If handled correctly, the investigation can improve employee morale and promote safety by showing management's concern for workers' well-being.

Require employees to report all accidents or illnesses immediately; the sooner injured workers get medical attention, the faster they'll recover and return to work. Plus, they may be less likely to file a lawsuit. Follow up with injured workers regularly and let them know how much you value them.

## Not going away

Grappling with the many safety threats to your workforce and the accompanying workers' compensation costs isn't likely to ever get easier, much less go away completely. So review your safety procedures and claims process regularly to ensure you're doing everything you can to manage this risk. ❌

## 3 reasons contractors should consider cloud computing

**B**y now, you've probably at least heard the term "cloud computing." It refers to an approach to information technology whereby you access part or all of your servers, networks and, most notably, software applications via an Internet-based service rather than buying and hosting them yourself. For contractors, there are a variety of reasons to consider this model. Here are three of the most compelling — and one caveat:

**1. Because it offers maximized mobility and accessibility.** If there was ever an industry that could use anywhere, anytime mobile access to its mission-critical data, it's construction. On any given day, your workspace (or that of your key employees) could be the front seat of a vehicle, a job-site trailer, or a client's home or conference room.

Cloud computing puts all of your important information just a Wi-Fi connection away. And that includes job cost data, billing and payroll info, blueprints and accounting records.

**2. Because it takes support, security and backups off your plate.** Many contractors struggle not so much with how to *use* technology, but rather with how to *maintain* it — and guard against risks. Outsourcing most or all of your servers and software to a third party means that the provider, not you, retains the responsibility for keeping those assets and data safe, running and backed up.

Clearly, there's risk involved. If your provider goes down, your operations could be paralyzed. But cloud computing companies' very survival depends on the consistency of their service.

**3. Because everyone is doing it, including construction companies.** Cloud computing has slowly



but surely been catching on throughout the business community. Revenue from cloud computing is on pace to rise from \$11.1 billion in 2009 to \$29.5 billion in 2014, according to a study by tech researchers International Data Corp.

More important, there are construction-specific cloud services from which to choose. One example is Deneb Software, which offers a completely integrated construction software package. Viewpoint construction software also offers a cloud computing option.

**The caveat: Are you ready?** Because cloud computing carries the risk of temporary or even permanent data loss should your provider fail, it's critical to carefully evaluate and maintain a close relationship with the provider. Are you prepared to do this?

In addition, for your company to reap cloud computing's benefits, your people need to be on board. Will your managers, estimators and other key employees adapt readily to the changes in functionality and accessibility? These and other questions will help point the way as to whether you're ready for the cloud. ☒

# The Contractor's Corner

## What's wrong with my project forecasts?

*I'm having a problem with the forecasts I ask my project managers (PMs) to provide. Their ballpark figures seem accurate enough when they submit them. But, by the time we're nearing completion, these numbers are often way off the mark. As a result, we either have to work twice as hard to get the job back in line with our estimate or simply lose money. What am I doing wrong?*

Like the weather in many parts of the country, the tenor of a job can turn on a dime. It's good that you're trying to get a rough idea of whether, financially speaking, the conditions ahead are sunny or stormy. But the operative word there is "rough."

### What to track

If you're merely interested in job status, you should probably just check out your work-in-progress (WIP) report. But what it sounds like you want to know is the estimated cost to complete.

To get a reasonably accurate read on this figure, a project forecast needs information such as your current budget (including the contracted revenue value and your initial numbers) and your actual costs to date broken down into various categories (such as "labor," "materials" and "equipment"). You may also want notes on impending subcontractor commitments and change orders.

In truth, there are many levels of detail you *could* ask of your PMs. Which ones you *should* ask for depends on what's been lacking in their previous forecasts. Remember,



the goal here is to accurately predict the factors pushing projected job revenue out of line with costs so that you can better control expenses.

### How to track it

Also important is the format of your forecasts. If your PMs' reports are just conversations over the phone or in the job trailer, you're likely missing all sorts of key specifics. Even if you're using a spreadsheet, it may be outdated or incomplete in terms of the data it calculates and presents.

*The goal is to accurately predict the factors pushing projected job revenue out of line with costs so you can better control expenses.*

To get really serious about project forecasts, look into your accounting software. Is it an enterprise system? That is, is your accounting functionality integrated with your other financial reporting applications? If not, it probably should be. This way, your PMs can use the most accurate, up-to-date data to generate their forecasts and share their reports companywide.

### A better idea

When it comes to construction projects, as with virtually anything else, no one can predict the future with 100% accuracy. But with the right information and an adequate amount of it, you and your PMs should be able to get a much better idea of where each job is headed. ☒

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