



Blueprint

Building Profits for Construction & Real Estate Companies

Construction litigation: *alternative dispute resolution & litigation support bring solutions to light*

by Roxy Baas, Evansville & Jim Snyder, Kansas City

Construction litigation is hardly a new phenomenon. Every generation seems to recall a more

"I was never ruined but twice: once when I lost a lawsuit and once when I won one." — Voltaire

perfect era when there was no litigation. The fact is, because of the volatile and constantly evolving nature of most large-scale construction projects, construction disputes and litigation are often a repercussion of the construction process.

Generally speaking, periods of strong economic growth seem to be accompanied or followed by periods of increased construction litigation, such as the speculative office building boom of the mid-1980s, followed by a plethora of owner suits against contractors alleging poor workmanship and overdue completion dates.

The 1990s saw a slowdown in actual litigation because the industry was forced to develop and use new strategies to reduce litigation, e.g., alternative dispute resolution (ADR), mini trials, mediation, arbitration and partnering.

Many contractors believe the current fast-track trend of project completion, i.e., moving construction from the drawing table to the field while plans are still in the

design phase, is a formula for disaster when coupled with the low margins currently experienced by the industry.

Consider this: in two of the

last five Construction Financial Management Association's (CFMA) construction industry financial surveys, participants selected litigation as one of the top challenges over the next five years.

Even though industry efforts

will continue to decrease construction litigation and its costs, one cannot deny that as long as there is construction, there will be disputes; and as long as there are disputes, there will be litigation.

Construction projects are high risk and prone to litigation for many reasons:

- ✓ They are unique, one-of-a-kind endeavors
- ✓ They are complex undertakings involving many unknowns and outside influences
- ✓ Many owners are inexperienced in the construction process
- ✓ Projects are high-cost under-

takings where overruns can destroy project feasibility

- ✓ The industry has many different segments: engineers, architects, construction managers, general contractors, specialty contractors and subcontractors
- ✓ The industry is highly competitive; of approximately 800 contractors who responded to the most recent CFMA survey, 60% of work-in-process and backlog was obtained by competitive bid, while only 39% was secured by negotiation (in the heavy/highway and specialty trades segments, competitive bidding is a much higher percentage of annual volume)

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Effective employee evaluations require skill

by Sarah Farrell, Kansas City

Many companies struggle with the formal process of evaluating employee performance.

Family-owned real estate and construction companies have the added challenge of balancing the relationship between employer-employee and employer-family member.

The challenge many owners face is to use an evaluation system that gives employees feedback on their performance and motivates improvement.

The system should provide well-documented paperwork to

defend situations involving termination or position and pay changes without creating a confrontational and demeaning experience for employees.

The complication for many construction companies is to accomplish all these objectives within a union contract framework.

Evaluations aren't so simple

On the surface, conducting an employee evaluation seems simple: one individual observes another's performance and determines how

effectively defined duties are performed.

This activity may occur every day outside the workplace, but it becomes more complicated within

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- ✓ Managing equipment for profitability requires vision
- ✓ Cash-basis companies reap tax benefits

Managing equipment for

by Dan Beattie, Kansas City

When managing for profitability, many contractors focus their attention on contracts. As a consequence, other important aspects of equipment operations, *e.g.*, purchasing, administration and financing, sometimes go unnoticed as potential profit centers.

To properly manage your business, these areas should be viewed as profit centers meeting



specific standards. Here's how to change your perspective.

Manage equipment investments

Financial statements may show contracts to be in a profitable position, but the equipment center will consistently show a loss or marginal profit in periods of high equipment usage.

Would a contractor own any equipment if equipment needs could be met through local, short-term rental, the costs of which later passed to the project owner? Probably not, but this is not how the real world works for equipment-intensive contractors who must accept the risks of ownership.

Before investing in equipment, it may be helpful to understand equipment management from the

perspective of an outside lessor. To accomplish this, it is important to:

- ✓ Identify the cost at risk
- ✓ Determine how these costs are to be recovered
- ✓ Develop a system to account for equipment costs and charge these costs to the contracts
- ✓ Establish procedures to monitor performance

Identify costs

It also is important to identify or estimate major recorded costs. These include:

- ✓ Investment maintenance costs, *e.g.*, repairs, maintenance and depreciation
- ✓ Carrying costs, *e.g.*, insurance, taxes, storage and other equipment division costs

In addition, certain costs may

never appear in the accounting records but are just as real as the recorded costs: cost of the company's invested capital (interest) and a reserve for the increased cost of replacement (inflation).

Recover costs

Once equipment is acquired, the objectives are to recover the above costs, return a profit through the use of the equipment and realize a residual value on disposal.

The primary method for recovering costs is through equipment rental rates. As previously mentioned, view yourself as a third-party lessor charging the contracts for equipment usage. The usage is charged at standard rates based on the hours or days in service.

Initially these rates are derived from one of the many equipment

Cash-basis companies reap tax benefits

by Jerald Isaacs, Tulsa

The cash-basis method of accounting generally recognizes income on receipt of cash or property and recognizes expenses when paid. At year's end, this can provide significant tax benefits for contractors with larger accounts receivable than accounts payable.

The cash-basis method allows some ability to manage year-end tax liabilities by deferring income and/or accelerating tax deductions by controlling cash flow.

Furthermore, the method a contractor uses for financial accounting purposes won't affect its eligibility to adopt the cash-basis method for tax purposes.

Who is eligible?

Until recently, the Internal Revenue Service (IRS) severely limited use of the cash-basis

method. Companies that maintained inventories and/or supplies were required to use the accrual-basis method of accounting.

With the release of Revenue Procedure 2002-28, those same companies may now use the cash-basis method of accounting provided they are not involved with manufacturing, mining, wholesale or retail.

Eligibility also is based on average annual gross receipts. For C corporations, or partnerships with a C corporation partner, average annual gross receipts cannot exceed \$5 million. If a business is other than a C corporation, average annual gross receipts cannot exceed \$10 million.

Think benefits

Another benefit to using the cash-basis method may be to avoid Internal Revenue Code Section

263(A), whereby the IRS requires certain overhead costs be capitalized into the inventory.

There are actually two methods of cash-basis accounting as far as the IRS is concerned:

- ✓ Overall cash method with inventories being accounted for under the normal IRC 471 rules
- ✓ Overall cash method with inventoriable items being accounted for as nonincidental material and supplies under Treasury Regulation 1.162-3

If a company treats inventories as nonincidental materials and supplies under Treasury Regulation 1.162-3, it is not subject to Section 263(A) but is not eligible to elect LIFO. If a company elects the overall cash method and accounts for inventories under IRC 471, it will be subject to 263(A) but eligible to elect LIFO.

Should you change methods?

Changing to the cash-basis method of accounting is an automatic change for most taxpayers and can be made at any time up to the extended due date of the income tax return for the respective year.

If the change reduces the amount of taxable income, the entire change can be deducted in the year of the change.

If the change increases the amount of taxable income, then the change can be picked up as income over a four-year period.

The IRS has made the cash-basis method of accounting available to more taxpayers than ever before. By changing to this accounting method, your company may be eligible to receive significant tax benefits. Contact your BKD advisor for more information. □

profitability requires vision

rate manuals developed on the basis of industrywide cost experience. As you gain experience, you will refine the rates.

Use market rates as the standard to return a profit and recover all costs over time, including those of capital and inflation. In addition, charge the contracts with idle time when equipment has to be on site even though it is not in use. The idle rate can be at a reduced percentage of standard.

Account for costs

It is common to account for all equipment costs in one pool of

accounts. This can be accomplished through a separate company or a separate division of the construction company.

The internal equipment rental to the contracts serves as revenue to the pool. Management's strategy determines whether the goal is to show a profit or break even for this division.

The hours worked by each piece of equipment can be accumulated through payroll records (treat each piece as an employee) or daily logs. Either way, record the hours in the job cost records at least as often as the labor.

Though this approach has the advantage of systematically spreading costs for extraordinary repairs over the contracts instead of charging them to a specific contract, it is important to maintain costs actually incurred and hours worked by each piece of equipment.

Monitor performance

To properly monitor equipment, it may help to review and modify rental rates regularly, and monitor operating performance, such as miles operated between

tire changes, major overhauls, etc.

In addition to evaluating the performance/profitability of the overall equipment division, maintain operating statistics for each piece or class of equipment related to the associated revenue.

Measure your equipment investment against a plan designed to enhance the profitability of the contracts. Sound practices in controlling equipment operations will allow you to take advantage of the good times and withstand the storms of the down times. □

Construction litigation: alternative dispute . . .

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Help is available

BKD has always provided timely and practical solutions to the challenges faced by our clients, and construction disputes and litigation are no exception. Our ADR services meet those needs.

BKD works closely with clients and their attorneys to help develop a comprehensive litigation or claim resolution strategy.

To evaluate a project, we use a systematic approach, one starting with detailed records and working up to entitlement and cost impact.

This approach helps us understand the interrelationships that exist between project records, issue files, contract documents, project cost records and schedules. It also establishes a correlation between problems and specific losses.

It's not enough to merely demonstrate that some portions of the contract were infringed and the contractor lost money; proof of how and the extent to which the two are causally linked is almost always required in the arena of dispute resolution.

When a claim is developed using a systematic approach, owners, A & E (architecture and engineering) professionals and contractors are more likely to negotiate contract changes, settle disputes and avoid more costly and time-consuming forms of dispute resolution.

BKD professionals serve as neutral arbitrators and mediators for a wide variety of disputes. Our team has the experience and training to handle and resolve disputes. In the context of mediation and arbitration, we provide sound, objective judgment on financial issues and have experience in the area of practical business interruption.

Our experience with the construction industry and our understanding of the methods of accounting and job cost records may save your company valuable time and money and may allow you to focus resources on current projects, not the details of a dispute. An outsider's objectivity can help identify issues and offer insight that might not be obvious

to an insider on the front lines.

When it comes to thorough, reliable and objective ADR services and/or litigation support, BKD is

your answer. Ask your BKD advisor for more details about how we can be a solution for you. □

Litigation support

Discovery phase - BKD's forensic professionals can set the stage, quickly and easily by compiling the necessary evidentiary items needed in litigation support:

- ✓ Identify key financial documents for inclusion in document requests
- ✓ Assist in drafting interrogatories on financial issues
- ✓ Assist in the preparation for deposition of financial experts and fact witnesses
- ✓ Interpret financial data gathered in discovery
- ✓ Develop or rebut damage calculations and other financial analyses
- ✓ Deliver expert deposition testimony and related written reports

Dispute resolution/trial phase - Many lawsuits are settled in the discovery phase and the best prepared party may have leverage. Our expertise in claim preparation and organizational and planning skills are invaluable during this stage.

- ✓ Finalize the best presentation of financial/claims-pricing issues
- ✓ Update the actual damages calculations or rebuttal of damages to be used for trial
- ✓ Develop demonstrative evidence for court
- ✓ Assist in formulating "last minute" settlement strategies
- ✓ Present expert testimony
- ✓ Assist in developing cross-examination questions for opposing financial experts and fact witnesses

Effective employee evaluations. . .

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the work environment.

For example, a fan at a baseball game may verbally comment on the performance of the baseball player on the field, but the fan does not control the player's compensation and career growth or have an ongoing relationship with the player.

Employee evaluations affect people's self-esteem and self-worth. The process places two human beings in a situation where individual expectations, biases, goals and motivations come into play.



Communication skills are important

Generally, the person who conducts the evaluation and the person who is evaluated aren't properly trained or prepared to deal with such a level of openness, and one or both may lack appropriate communication skills necessary to capture the true value of the experience.

When two potentially nervous or defensive individuals meet for an evaluation, they often seek to end the experience as quickly as

possible, creating a negative and demotivating experience for both. If a manager takes the easy road by avoiding any truthful discussion of performance, it may render the evaluation totally ineffective.

The problem with many employee evaluation systems is the

creation of a parent-child atmosphere where the "parent" manager needs to correct inappropriate behavior and make subjective decisions based on his/her own personal values about the overall performance of the "child" employee. Meaningful discussion is further compromised if the manager takes a dictatorial approach.

Encourage achievement

Employees seek objective, constructive feedback. Managers who use a coaching approach to

build an effective team and/or organization seek peer input and are unafraid of input from subordinates about their own performance as managers.

Employees work best with managers who are focused on supporting the goals of their employees and the achievements of team and company goals. Employees do not reach their best performance with managers whose primary concern is to protect their own power, perks and position within the company.

Use effective evaluation systems

To conduct effective employee evaluations, use a well-designed employee evaluation system. Be sure it includes several important features:

- ✓ Focuses on the employee's contribution to the team or company
- ✓ Places the manager in the role of coach, not judgmental parent
- ✓ Concentrates on the positive and employee career growth
- ✓ Encourages daily staff feedback
- ✓ Evaluates the whole person, not just certain skill sets or ambiguous qualities

- ✓ Demonstrates caring for and interest in the employee
- ✓ Encourages peer and upward appraisal input
- ✓ Provides a vehicle for open feedback, not just compensation determination

An employee evaluation system should be a valuable, productive process that allows management and staff to gain a better understanding of themselves and their responsibilities. It should serve as a motivational tool that opens lines of communication and clarifies organizational goals.

Developing a true team environment should be every real estate and construction company's goal. Our human resource professionals can help your company develop a new evaluation system or improve an existing one through program development and staff training. □

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