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# Construction Insider

*Insights & Observations for the Construction Industry • Summer 2008*

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**THE NEXT  
LEVEL OF  
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## Your Pathway to Success

By Joseph Natarelli, Partner and National Construction Group Leader and Robert Mercado, Partner

In the last edition of Construction Insider, we discussed how contractors fail when they accept jobs that are too big or spend money on items they don't need. In this edition, we discuss how you can avoid common financial pitfalls by hiring a good CPA to advise you on these issues throughout the year.

The construction industry is unique in that it relies heavily on estimates, and improperly estimating your costs can quickly ruin your financial well-being. When you acknowledge and accept that this industry has a very high failure rate, you can start taking the right steps to protect yourself. In a high risk industry, calculated decisions and good advice should elicit higher rewards. Hiring the right CPA is critical, and you won't regret taking this important step to bolster your success.

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## Changes to the AIA General Conditions

By April F. Condon, Counsel at Robinson & Cole LLP

The construction and design contracts published by the American Institute of Architects (AIA) are arguably the most commonly used construction and design contracts in the United States. Approximately every 10 years, the AIA revises these documents so that they reflect current industry trends and practices. In late 2007, the AIA released, along with other revised documents, the 2007 edition of the A201™ General Conditions for the Contract of Construction (the "General Conditions"). Changes to the General Conditions have a great impact because they are incorporated into many AIA construction contracts (including those between owners and contractors and those between contractors and subcontractors) and because they establish many of the rights and obligations between the owner and the architect.

The revisions to the General Conditions, as incorporated into the A201-2007, are many and significant. A sampling of the most notable changes is summarized here.

**Initial Decision Maker for Disputes.** For nearly 100 years, the General Conditions designated the architect as the initial decision maker of all claims and disputes arising in connection with a construction project. Some contractors have argued

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Take a serious look at different CPA firms to find the one that will be a true asset to your company and not simply another line item in your budget. The right CPA will help you better manage your cash, improve estimates of your job costs and percentages of completion, and help you with bank planning, income tax planning, and capital and financial needs planning before year end. Don't automatically hire the firm with the lowest fees; consider how much construction accounting experience a firm has and hire the one with the most.

A good CPA can also help you work with your surety and your banker by verifying that you have financial statements, appropriate interim and annual schedules, and schedules of contracts in progress, contracts completed, backlog, and disclosures about the extent to which contract billings are used as bonding collateral. Your CPA can meet with your surety agent to explain, for example, specific and legitimate reasons why you might have costs in excess of billings on your balance sheet.

**Job Costing Systems.** Estimates and quality job costing are more important in the construction industry than any other. Contractors must set their prices in the bidding process before ordering supplies, beginning work and knowing costs with certainty. Estimates are used to predict remaining work, to report revenues and to determine interim profits on contracts. In construction, estimating gross profit and percentage complete is essential to operating and accounting since working capital, revenue and equity are derived from these estimates and are all bases for your bonding agents.

The risk associated with these estimates that can be reduced if your company has a job costing system that reliably captures all contract costs including labor, material, equipment and other direct and indirect costs for individual contracts. It is important to remember that a contractor's risk exists entirely in individual contracts, not in contracts as a whole.

**Profit Fades.** "Profit fades" is a term used to describe the decline in estimated gross profit margins from the time a contract begins to the time it is completed. For example, you might show a projected 15% profit when a job is open, but actually have only a 10% profit when it closes. One of the principal reasons why contractors show profit fades is poor estimating. When a company consistently shows gross profit fades, its bankers and sureties discount its financial capacity even more than the percentage of the fade. So, for a job with

a projected 15% profit but an actual 10% profit, a surety will apply a larger discount on a contractor's financial capacity than just five percent. Consistent profit fade indicates that you don't know how to estimate jobs, and a surety will use your past performance as a predictor of the future.

**Working with Subcontractors.** If your company works with subcontractors, your job costing and estimating system must properly account for their billed versus paid costs. Subcontractor bills should be consistent with the percentage of completion shown in their work. When a company pays subcontractor costs before they are incurred, those costs are prematurely charged to a contract and it appears that you have overstated your revenues. When a contract is completed, the true revenue amount often looks like a profit fade.

**Watch Cash Flows.** It is virtually impossible to overstate the importance of cash flows when evaluating the viability of any company, including construction companies. CPAs, sureties, bankers and investors agree that poor cash flows expose your company to risks that can quickly cause financial disaster.

Remember, a good contractor is always overbilled and always uses the project owner's funds to finance a project – not its own working capital and equity. Don't rely on cash flows from other jobs to make up shortages, because you may end up funding loss jobs and not even know it.

**Internal Controls System.** A good internal controls system is necessary for a contractor to thrive, since a deficiency in internal controls creates incredible financial and credibility risks. A successful

internal controls system should encompass all systems and personnel participating in production management, cost administration and contract management so that you can properly track cost measurements and allocations, equipment and other assets, timely billings, quality work standards and compliance with laws and contracts.

Contractors rely on accounting systems to provide information about overhead, payroll, supplies and equipment costs. These are crucial to preparing bids and knowing where your company stands on each contract once work begins.

When production quality controls aren't in place or aren't functioning properly, contractors run the risk of incurring unnecessary materials and supply and labor costs to correct defects in workmanship or product quality. Even if your supplier guarantees the quality of materials and supplies, contractors still incur labor and other costs if defects aren't discovered before materials are used.



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that architects are incapable of being impartial since they are hired and paid by owners. Some owners have expressed their preference to have the architect act as their advocate in disputes rather than as a required neutral party. The A201-2007 addressed this issue by permitting owners and contractors to designate a third party as the initial decision maker for all disputes. While not every project will justify the cost of engaging a third party to resolve disputes, the contract parties now have that option. The architect remains the default option, so if no third party is specified in the contract, the architect shall serve as the initial decision maker.

**“Check the Box” Dispute Resolution.** Since their inception, the AIA documents have required mandatory arbitration of disputes not otherwise resolved through mediation. Throughout the years, contract parties have increasingly struck such arbitration clauses from contract forms. The AIA responded by providing parties to the A201-2007 with a choice of binding dispute resolutions. Such choice is made through the checking of a box marked “litigation,” “arbitration,” or “other.” If no box is checked, the default is litigation. If the parties choose arbitration, they may also choose the provider of arbitration services. This is an additional change since the General Conditions previously required that arbitration be administered by the American Arbitration Association.

**Consolidations of Arbitrations.** Previous iterations of the General Conditions expressly prevented a party from joining the architect as a party in a dispute between the owner and the contractor, and some argued that the provision was overly protective of the architect. The A201-2007 now specifically permits the architect or certain other parties to be joined in arbitration if certain conditions are met.

**Financial Disclosures.** The A201-2007 establishes some restrictions on the contractor’s right to receive financial information from the owner during the course of the project. Under the A201-2007, after work commences the owner is only required to provide the contractor with evidence of its ability to make payments under the contract documents if (1) the owner has failed to make payments to the contractor as required under the contract documents, (2) a change in the work materially changes the contract sum, or (3) the contractor identifies in writing a reasonable concern regarding the owner’s ability to make payments under the contract documents when due.

Additional revisions reflected in the A201-2007 afford the owner a greater opportunity to learn of payment problems between the contractor and subcontractors, and to address the contractor’s failure to pay a subcontractor by allowing the owner to write joint checks.

**Time Limits on Claims.** Previous editions of the General Conditions required “contractual” time limits on claims. The

A201-2007 provides that the time limit for commencing causes of actions is determined by applicable law, but in no case more than 10 years from substantial completion of the project.

**Additional Insured Provisions.** The A201-2007 has removed the requirement to provide Project Management Protection Liability Insurance, which was required in previous editions of the General Conditions. In its replacement, the A201-2007 now requires that the contractor add the owner, the architect, and the architect’s consultants as additional insureds under the contractor’s general liability policy.

**Conclusion.** The A201-2007 contains many other significant departures from previous editions of the General Conditions. All parties to the AIA documents impacted by the A201-2007 are advised to carefully review and consider each change before using the new form of General Conditions for any particular project.

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# Simplifying Surety Bonds

By Joseph Natarelli, Partner and National Construction Group Leader

If you own a home, car, business or boat, you know it is vital to have insurance policies to protect these important investments. In the construction industry, it is equally important to obtain a similar type of guarantee, or surety bond, to protect yourself in the event of a failed contract or unfinished work.

**Why is it Required?** The Miller Act of 1935 mandates performance and payment bonds for all federal public works contracts for more than \$100,000. Payment bonds are preferred for contracts worth more than \$25,000. A performance bond guarantees that a contractor will perform the work and a payment bond guarantees that a contractor will properly pay its subcontractors. Keep in mind that each state has its own “Little Miller Act,” a version of the federal law designed to guarantee work on state government contracts.

**What is it?** A surety bond agreement is a legal way of requiring a contractor to do its job and the project owner to pay for services rendered. The surety company oversees this agreement and will step in on behalf of either party should there be a claim of default. At that point, the surety determines whether allegations are true and takes appropriate action. The bond is designed to prevent a loss, since each party stands to suffer a penalty should there be a claim made on the bond.

**How Much Does a Bond Cost?** There is typically a low expectation of loss when underwriting a surety bond, so the premium is usually a basic fee for prequalification services. It is important to note, however, that surety companies prequalify based on your financial strength and construction expertise, so it is essential to maintain good financial records, internal controls and job costing procedures.

**What Happens in the Event of Default?** If the contractor has defaulted, the surety may re-bid the project, pay the penal sum of the bond or arrange for a replacement contractor. The project owner is still responsible for payment, but to the surety and not the contractor. The contractor is required to pay the surety for any losses incurred by the surety resulting from its failure to fulfill a contract.

**What if I Can't Pay the Penalty?** The key is never to default on your bond. However, if you do and cannot afford to pay the penal amount of the bond, the parties who signed your General Indemnity Agreement will be held liable. Surety companies require contractors and other parties willing to support the contractor to sign this agreement. This protects the surety from loss since any person or organization committing a signature to the agreement is liable for repayment to the surety if a contractor defaults on its contract.

## Bid Bond

**Description:** States that surety believes the contractor has the ability and resources to complete the project at the bid price. Assures that contractor will file its performance and payment bonds if awarded the contract. Used by owners to prequalify contractors.

**Surety's Responsibility:** If contractor is awarded the contract but refuses to sign it, surety must pay the owner the difference between the winning bid and the next lowest bid.

## Performance Bond

**Description:** Guarantees that the contractor will complete project as specified by the contract.

**Surety's Responsibility:** If contractor deviates from contract terms, surety must reimburse the owner for any losses.

## Maintenance Bond

**Description:** Guarantees against any faulty workmanship or materials. Usually good for one year after construction is complete.

**Surety's Responsibility:** In the event of faulty workmanship or materials, surety must reimburse owner for any losses.

## Payment Bond

**Description:** Guarantees payment to subcontractors and suppliers. Assures owner that project will be free of liens from unpaid subcontractors or suppliers.

**Surety's Responsibility:** If contractor fails to pay subcontractors or suppliers, surety is required to pay.

## Completion Bond

**Description:** May be issued in lieu of performance and payment bonds. Guarantees the contractor will perform and pay for all contracted work.

**Surety's Responsibility:** If contractor fails to perform, surety must find another contractor to finish the work.



## Construction Employment Statistics: Anticipating Staffing Shortages

Check out the *Construction Insider's* results summary of the Construction Financial Management Association's annual survey of industry practices. Many construction professionals expected sales to increase in FY 2007 and at the same time are concerned that a shortage of trained field staff would be the most crucial threat to success in the next five years.

If optimism and confidence are still prevalent in the industry, a staff shortage would certainly put a damper on potential success. So what are the current trends facing staffing in the construction sector? The chart below demonstrates the change in the number of people employed in the construction sector since 1990. The numbers appear to have stayed relatively static in the last three years, and have not dropped significantly since the mid-1990s. Whether the consistency of the last several years indicates a steady future, or forebodes a sharp decline, is yet to be seen.

The Department of Labor defines the construction sector as establishments primarily engaged in the construction of buildings or engineering projects (e.g., highways and utility systems). Establishments primarily engaged in the preparation of sites for new construction and establishments primarily engaged in subdividing land for sale as building sites also are included in this sector. Construction work done may include new work, additions, alterations, or maintenance and repairs. Activities of these establishments generally are managed at a fixed place of business, but they usually perform construction activities at multiple project sites.

<http://www1.ctdol.state.ct.us/lmi/SecEmp.asp>

## CFMA Survey Results

The Construction Financial Management Association released the results of its annual survey of construction industry practices in late 2007, which revealed the consistencies and obstacles currently facing the industry.

A much larger pool of companies participated in 2007 compared to 2006, and the annual revenue of the respondents ranged from \$10 million to more than \$100 million. The following summarizes the findings of the CFMA survey.

- Last year, respondents expected sales volume to increase. The average gross margin did increase from 8.3% in FY 2006 to 10.2% in FY 2007.
- Debt to equity fell from 2.5 to 2.4.
- Backlog revenue increased by 26%.
- Composite balance sheet had total assets of \$55.8 million, total net worth of \$16.3 million and total revenue of \$157.9 million.
- Majority of respondents are optimistic and expect sales to increase in FY 2007.
- Some concern about challenges to profitability including rising health insurance costs.
- Shortage of trained field help cited as most crucial threat to success in the next five years.



## Going Green: The Potential Economic Benefits of Eco-Friendly Construction



“Going green” is becoming undeniably more popular every day. It is also true that using environmentally-friendly building materials, and implementing innovative ways to harness and conserve energy, is more expensive than

traditional supplies and methods. If you have considered establishing a niche in green construction, you may wonder what benefits there are - besides the satisfaction of using sustainable materials - in making this decision.

Contractors in several states are starting to reap some tax and other economic benefits for using green materials. Such credits and assistance are not currently available in Connecticut, but with impending green requirements mandated by the State, this may change.

The U.S. Green Building Council has created a certification system called Leadership in Energy and Environmental Design, or LEED. Buildings in the LEED rating system earn points toward levels of certification depending on how many green features are included in the building's design and construction. Buildings initially can earn basic certification. New buildings with additional green features can earn ratings of silver, gold or platinum. Among the measures that can earn points are enhanced energy efficiency, use of renewable energy, water conservation, environmentally sensitive site design, redevelopment of Brownfields and stormwater management. Buildings must be rated by an independent rater certified by the U.S. Green Building Council.

The Connecticut Office of Legislative Research released a summary of the LEED program and how it will impact Connecticut building projects:

PA 07-242 requires the state building inspector and the Codes and Standards Committee to amend the State Building Code to require (1) buildings costing \$5 million or more built after January 1, 2009 and (2) renovations costing \$2 million or more starting January 1, 2010 to meet the LEED silver standard or its equivalent. The requirements apply to private and public sector projects, other than residential buildings with up to four units. The act requires the inspector and the committee to waive these requirements if the Institute for Sustainable Energy finds that the cost of compliance significantly outweighs the benefits.

The state does not currently provide financial assistance for building owners or developers specifically to meet or exceed its green building requirements. The state does exempt various energy efficiency goods, such as furnaces that meet federal Energy Star standards and insulation, from sales tax. It also requires municipalities to exempt several types of renewable energy systems from property tax. Buildings that use renewable resources systems to generate electricity can also take advantage of the state's net metering law, which requires electric companies to buy the power produced by these systems, in effect running the electric meter backwards.

In addition, legislation has been proposed that would create a credit against the corporation tax and other business taxes for investments in green buildings. The building would have to meet specific energy efficiency standards as well as be certified under the LEED system. The amount of the credit would depend on the building's rating under the LEED system and would have to be claimed over a five year period. The bill would authorize a total of \$50 million in credits starting in 2010; in the case of new buildings, the building would have had to obtained its certificate of occupancy no earlier than January 1, 2009.

Ultimately, it behooves contractors to consider the tax implications, rebates and other benefits of environmentally-friendly construction. Keep in mind that companies may not be eligible on buildings constructed for others, but building owners and subcontractors will be. Companies can be environmentally-conscious and save money, however, through tax rebates, LEED incentives, recycling the core and shell of existing buildings, using energy-efficient devices and maximizing natural energy sources.

A good CPA will help you identify the appropriate benefits for your firm and guide you through new and complicated tax codes and legislation in order to maximize your ROI.

<http://www.cga.ct.gov/2008/rpt/2008-R-0162.htm>

## Bureau of Labor Reports Major Increases in Iron and Steel Prices

The U.S. Department of Labor, Bureau of Labor Statistics reports prices for iron and steel scrap surged 32.2 percent compared with a 1.4 percent increase in March. Prices for hot rolled steel bars, plates and structural shapes increased 6.2 percent in April compared with a 2.5 percent gain a month earlier. The index for materials and components for construction advanced 1.0 percent in April after rising 0.8 percent in March. Prices for fabricated structural metal products jumped 3.1 percent in April following a 1.0 percent increase in the preceding month.

[www.bls.gov/news.release/ppi.nr0.htm](http://www.bls.gov/news.release/ppi.nr0.htm)

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## Construction Industry Insight

Our teams of experts are organized nationally by industry, which allows us to offer clients the best-in-category knowledge we have gained from working with similar clients in the industry or service specialty.

Our construction expertise includes:

- In-depth knowledge of the construction industry
- Knowledge of the surety market
- Leadership and participation in rule-setting
- Clients with a wide range of construction activities (general contractors, underground contractors, underwater construction, casino builders, tunnel, bridge and heavy highway); sizes range from start-ups to \$1 billion in annual revenue

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