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# Construction

*Better Ways ▲ Better Results*

A NEWSLETTER FOR THE CONSTRUCTION INDUSTRY

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## What Makes Incentive Programs Effective?



An effective incentive program takes planning and organization. It also requires ownership — a company leader tasked with championing the project. Following are some other principles of effective incentive plans.

### Performance Is the Issue

Incentives can take many forms, and they can aim to achieve a variety of results. But in all cases, the most effective incentives are those based on specific performance goals.

Individual goals can vary widely, of course, and a project manager's will be different from those of a roofing-crew chief. By setting goals carefully at every level, a company can align its employees' efforts more closely with its strategic direction and overcome specific obstacles that are holding it back.

### Self-Funding Budget

The incentives budget should be performance-based — that is, it should be funded from the benefits the incentives are designed to produce. Business improvements, such as a reduction in time lost to illness, for instance, can generally be projected and measured in financial terms. The alternative is to build incentives into each project's direct costs. But few contractors have that luxury, since they're competing with bids that don't reflect that approach. It's far better to tie the incentives to specific performance improvements.

Construction contractors, like other business owners, sometimes take a less-than-objective approach to incentive pay. Some owners simply compare their year-end profits to those of the year before, draw up bonus figures for some or all their employees and hand them out before the holidays.

If this procedure could be said to reward performance, it's only in a general, undifferentiated and subjective way.

A better approach for contractors is to structure incentive programs thoughtfully — not only to reward people, but also to drive specific improvements in the business. Higher productivity, reduced absenteeism, fewer accidents and higher employee retention rates have all been achieved in part through carefully targeted incentives.

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# Managing the Closeout Process

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As a construction job draws to a close, a contractor's interest can be diverted elsewhere. After all, there's other work to be done, and supervisors are needed on other sites.

But the last stages of a job require management attention, too. Most importantly, when a job ends, a construction company should study its own performance and produce a closed-job report.

Such a report can establish a formal end to a contract and provide the contractor with valuable lessons going forward.



## How Profitable Was It — and Why?

A closed-job report gives you the opportunity to look back on a percentage-of-completion job to find out how profitable it was and why. By knowing the "why," you can develop more precise and accurate bids on future jobs and, over time, focus on more profitable contracts.

Among the functions a closed-job report can perform are these:

- **Declare the job complete.** Closeout marks the end of a contractual relationship between contractor and owner.

When an understanding is in place between site supervisors and accounting personnel that no more work will be done on a job, it's reasonable to declare it over.

But processes must also be in place to modify the report for post-job requirements. Warranty work, for example, can come up long after a job is complete. Various accounting software systems let contractors include warranty-work costs in a completed job, or accumulate such costs in a separate account.

- **Account for all change orders.** Contractors should be satisfied that the costs and billings for all change orders have been added to those of the job itself. This may involve choices: When should orders be recorded? Should all revenue be recorded, or just revenue up to the cost of the order?
- **Account for retainage.** Has retainage been billed and recorded? Different techniques are used to track billed and unbilled retainages, but the process must be consistent to ensure that the accounting for such transactions is correct. And closing a job means following up on your billings, too. Have you been paid?
- **Open a window on profit fade.** Profit fade occurs when the gross profit percentage is reasonable or even high in the early stages of the job, but becomes lower

and lower as time goes on due to revisions in estimates of job costs.

Contractors can analyze profit fade on the basis of completed closed-job reports by sorting jobs according to estimator, project manager, job supervisor, etc. If trends appear, they can be factored into the bidding process.

- **Conduct post-completion job audits to review budget variances and overruns.** Actual figures collected over several jobs will help put future cost estimates and bids on firmer footing.

## Point of Substantial Completion Is Critical

It's also critical to determine substantial completion, because that calculation dictates when profit is recognized.

Generally, substantial completion should be declared when remaining costs and risks are insignificant. A consistent approach is important in order to avoid the temptation to recognize completion on some contracts earlier than others. And the method used to determine substantial completion should be disclosed in accounting documents.

*Detailed closed-job reports can help your company bid more effectively. Our firm can help you put them together. For more information contact Joel Dzedzic at 630-545-4508.*

### Incentives for All

Incentive programs fail for different reasons, but one common cause is a failure to recognize and reward performance up and down the line. Some contractors repeatedly reward project managers and executives but not front-line supervisors or hourly workers. Owners may not hear the grumbling, but it's there, and it can be an obstacle to the very improvements the company needs most.

In a comprehensive incentive program, on the other hand, a company offers every employee — from executives to laborers and administrative assistants — the opportunity to earn something of value by improving their performance on the job. Of course, different metrics and rewards apply at different levels, but companies that implement such comprehensive programs report leaps in morale and energy.

### Different Strokes

When it comes to rewards, craft and hourly workers typically prefer cash. Stock options or other long-term rewards may be of more interest to salaried employees looking toward a long career with the company, but immediate monetary awards rarely bring complaints from them, either.

Non-cash awards can have advantages, though. Through deals with merchandise or service companies, contractors may be able to deliver incentives of greater value to some employees. Still, since not everyone responds positively to a bass boat, some diversity in awards is a good idea.

Catalog programs provide such diversity, including new Internet-based programs that offer immense selections from a multitude of vendors. Some contractors award incentive tickets for various achievements during the course of a project, which employees can redeem for catalog merchandise at the project's end.

### Incentives for Management

An incentive program for management should proceed from the same assumptions as one for hourly workers. Its purpose is to drive results, so it should be based on performance.

Because managers are responsible for groups of workers or other managers, collective results provide the baseline for the rewards. The company should set milestones based on its own needs — less rework, faster framing, a better safety record — and reward managers and supervisors for exceeding these goals. By raising these bars carefully, contractors may see significant improvements over time. Companies that give management bonuses for project work generally hold them until project end. They know that, given the nature of the construction business, they may need that money during the project.

Contractors should also resist the temptation to let incentives and

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## A Show-up Incentive for Hourly Workers

FrameWork, Inc. had plenty of work but not enough workers. For whatever reason — flu virus, fishing season — too many employees were taking too many days off.

How much does a day of absenteeism cost a company? Construction science organizations consider all the various disruptions an employee's absence can trigger — project delays, idle time, shifts in personnel, even a lost crew-day. On average, researchers say, the cost of an employee's absence is equal to the employee's hourly rate times 12.

That means that when a \$20-per-hour crew lead misses a day, the contractor is out around \$240. FrameWork's owners figured up their absenteeism costs for a year and decided to set aside half that amount in a budget for a "show-up" incentive program.

For every month of perfect attendance, employees would receive a bonus along with their paycheck. The amount of the incentive would be dictated by the budget. The company brought front-line supervisors in on the deal too, giving them a stake in their crews' show-up performance.

This approach is successful because it provides "line-of-sight" targets — goals employees can influence immediately by their own actions, which seem less abstract than gross margins at project end.

The program had a big impact, and a year later its returns were plain to see. The drop in absenteeism (and the resulting drop in costs) had saved the company significantly more money than the show-up incentives had cost. And since the program was self-funded, paid for by the savings generated from improved performance, it carried little risk.



# Construction Briefs

## Fraud Triangle Still Rings True

The instances of construction fraud we've examined in recent issues, like all fraud, share some basic foundations. By understanding them, owners can strengthen their defenses.

The foundations of fraud, said criminologist Donald Cressey in the 1950s, can be seen as a three-sided triangle of pressure, rationalization and opportunity. For a fraud scheme to develop, said Cressey, all three sides must be present.

Pressure comes with life. A husband's layoff, a credit card debt, a bad run in Vegas, an appetite for luxury, a failure to meet business goals — all these things can have serious financial consequences.

And the cure for those, most people agree, is money.

Rationalization is the fraudster's contribution. We're all under pressure, but we don't steal copper wire or pay fictitious vendors. Most frauds, in fact, are committed by employees who view themselves not as criminals but as ordinary and honest people — people for whom such behavior requires a personal leap of morality, logic or both. (I was just borrowing it. They owe it to me. The boss is a crook anyway. Everyone does it. My family needed it.)

Opportunity is the third side of the triangle. Even under pressure and armed with a rationale, a must see a way to steal, and steal with impunity.

If daily life provides the pressure and the fraudster provides the rationale, who provides the opportunity? The employer does. And when the employer withdraws the opportunity, fraud fizzles.

When any leg of the triangle is missing, Cressey explained, fraud schemes can't develop. If there's no pressure, why bother? People who can't rationalize stealing don't steal. And without an opportunity, even the most committed fraudster — desperate with debt, armed with flawless dream-logic — can't steal from you. ■

*Our firm can help your company remove opportunity from the fraud triangle. For more information contact Dave Kot at 630-545-4518*

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bonuses make up too great a proportion of total compensation. This generally happens for two reasons. One, when the company sees the impact of well-designed incentives, it decides that more must be better. Or two, the company simply finds that incentives, which are variable and based on revenue, are easier to manage than the fixed costs of paychecks and salaries. Either way, the company begins to neglect pay increases in favor of bonuses.

In good times, no one complains — for employees, it's all good money. But the problem shows up in a downturn, when incentives and bonuses necessarily dry up and employees are left with a base pay that may be substantially below market rates. ■

*Is your company using incentive awards effectively? For more information contact Vito Loisi at 630-545-4554.*