

# SMART *Construction*

Strategic Management | Analyses | Interviews | Trends

November 2010

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# Introduction

Dear Readers,

I would like to present the first issue of SMART Construction magazine, a publication prepared by the Czech Association of Construction Businesses in cooperation with the advisory firm Deloitte and ÚRS Prague.

The magazine is primarily intended for senior and middle management of construction companies and aims at bringing in new perspectives of various aspects of construction management and at providing information that can transform the construction industry into a "SMART" and knowledge-based one. The title of the magazine represents its essential contents, ie articles concerned with **S**trategic **M**anagement, **A**nalyses of the industry, **i**nte**R**views with industry leaders and the approximation of **T**rends and successful examples in the industry.

Neither the current situation, nor the anticipated development in the near future are positive, therefore each construction company must have a high-quality strategy based on which its business plan, organisational structures and processes will be adapted to the new situation and trends. The subject matter of the Strategic Management section and the article entitled "Future Strategies in the Construction Industry" is a search for new, more efficient methods of construction company management and an increase in the efficiency of construction. Each issue of SMART will also include comments on construction results. The current issue includes an analysis of figures for the first eight months of 2010. The Investment Strategy section presents the investor and developer sphere, ie construction contractors. This issue covers thoughts regarding the future construction of further shopping centres in the Central European region. Additionally, our first issue contains an interview with Libor Joska, CEO of Enteria.

The objective of this publication is not to provide instructions and advice to construction companies; it rather provides information about possibilities and opportunities, warns against risks and presents possible solutions and opinions for discussion.

I believe you will find our publication interesting and will find information and suggestions in it that could be useful for your business.

**Václav Matyáš**

President

Association of Building Entrepreneurs of the Czech Republic



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# Future Strategies in the Construction Industry

The outlook in the construction industry is currently not very positive. Demand from the private sector, which experienced a downturn last year, is still very low and goes hand-in-hand with restraint in investments by the public sector. Unlike manufacturing, which is slowly beginning to recover thanks to exports, the recovery in construction which is hugely dependent on local demand will be delayed for some time. Moreover, the distortion in relationships between investors and suppliers will remain long after the crisis is over and may never change. How should construction companies react to the current situation? In the following article, we will try to outline possible answers to this question.

## Independent Review of Strategy

It is estimated that approximately one fifth of construction capacities will disappear from the market. Construction companies must react to the new situation; certain companies should carry out an efficient reorganisation during the first phase and adjust their management structures, activities and capacities to lower turnover. For some companies, an independent assessment of the current state of their business can be useful, not only with regard to the financial indicators which assess historical data but namely with regard to their future and the suitability of the selected strategy. This includes an assessment of the business plan's quality, the business and production model, specialisation appropriateness of the organisational structures and an assessment of the company's flexibility rate.

## Specifics of the Czech Construction Market

The construction market is distinctive in its large volume of cash flows and relatively low margins, which results in quite a high risk rate for the industry, a fact predominantly perceived by financial institutions. The first reaction to a market decrease is cutting of costs and staff reduction, which itself is not sufficient and only works on a short-term basis. Subsequently the company finds out that without the dismissed employees, ie low productivity, it is not possible to finish the projects in progress. In this sense, problems are also caused due to the change in the demand, where companies compete and realise a high number of small projects instead of several large ones. Therefore, companies will have to apply measures in the second phase which will systematically eliminate inefficiencies in construction.

## Revolution Instead of Evolution

The future construction strategy does not involve the evaluation of what we are doing now and the intention to do it better; the future of the industry and of successful companies lies in changing their way of thinking. While other industries witnessed revolutionary changes in the past decades, and their commensurate increases in efficiency, the conservativeness and resistance to change in construction companies resulted in these changes being poorly reflected in the global construction industry. The construction industry will unavoidably experience similar development in the future. And although, due to its character, ie the uniqueness of each project, it will never achieve the values of automated production, there is a large potential for changes and improvements.

## Customer Focus

In other industries, the best companies are always customer-focused. The customer is at the centre, he manages everything and everything is subordinate to him. Industry leaders do exactly what their customers want, whenever they want it and for a price which is appropriate for them.

From our experience we know that the majority of construction companies neither inquire about what their customers really want, nor retrospectively check their satisfaction (in other industries known as "Customer Relationship Management"). Price setting is often based on the cost-plus method without searching for and accentuating the added value or savings for the customer (a concept known as "Value Engineering"). Construction companies should start to systematically cooperate with their customers, their needs and the perception of added value and quality. The creation of a strategy should always start with an evaluation of what is the best the company can do and offer, and a determination of a target client, market or segment.

## Lean Construction Concept

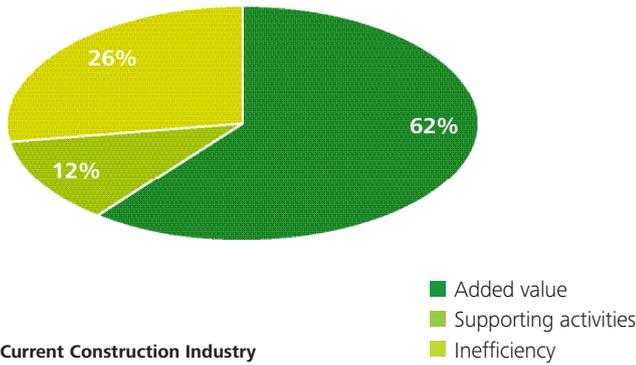
The opportunity for an increase in efficiency and an overall decrease in expenses lies in the implementation of new management approaches, such as lean construction, representing an increase in the efficiency and flexibility of all business activities, including support and production activities. This, however, requires auditing all business processes and activities in the company and resetting them. It represents the identification and support of activities which bring added value (qualitative and quantitative) and the elimination of those which bring a negative value. Each activity, process and transaction must have a justified economic purpose.

The idea of lean construction represents application of a production-based management approach (Toyota). This approach is based on the reduction of inefficiencies in all construction activities which use resources but bring no added value, and also on the elimination of waste and time delays. The foundation of lean construction is the pursuit of zero waste and maximum construction continuity.

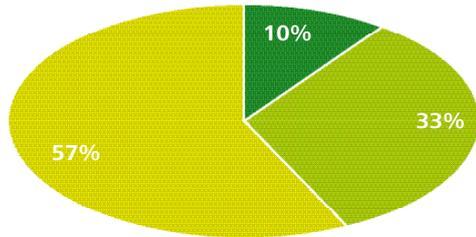
There are several definable areas where the majority of "drivers of waste" are concentrated and these must be systematically minimised. These include deficiencies which require correction, delays in construction, performance of unnecessary activities and pointless movement of people, machinery and material. Another significant cause of waste is waiting on follow-up resources (capacities, people) to complete activities delayed due to mistakes by previous resources as well as inadequate realisation (bigger machines, unnecessary steps, redundant planning).

Necessary prerequisites for the implementation of lean construction are uninterrupted material supplies (possibly "just in time"), the elimination of wasted spaces for material storage at construction sites, greater manager control of supplies for construction, and predominantly the breaking of questionable bonds between site managers and suppliers. The review of consumption for individual projects needs to be changed from "ex post" to "ex ante".

**Current Production**



**Current Construction Industry**



Source: Construction Industry Institute, The University of Texas at Austin

**Centralisation of Support Activities**

For mid-sized and large businesses, central purchasing means the implementation of a new process in the company, not the establishment of a central warehouse. The aim is to gain centralised control over the costs of material, goods and services and thus decrease project costs and increase quality. Central purchasing will also enable unified pricing and significant discounts for all company divisions. Controlling consumption ensures quality.

Given their size, small companies often have nothing to centralise. Nevertheless, they have the possibility to form strategic alliances with other companies, which may result in a significant decrease in costs of output material and administration.

**Project Controlling**

Project controlling monitors the project from the material and economic perspectives in all its decisive phases, starting with the primary registering of interest in an order, preparation of a proposal, concluding a contract for work, realisation of the order and the expiration of the warranty period.

The wrong use of the batch mode, such as based on monthly analyses, means the inability to immediately react to change. Standard economic information system tools are insufficient for project controlling which records costs and income of products/orders. Unplanned events, change proceedings and deviations can only be controlled exceptionally; there is no critical functionality, such as the integration of deadlines in planning and evaluation. Currently, excel tables etc are used for everything, although more sophisticated software exists, since people have to first be trained to use this software.

And finally, by reviewing consumption in individual projects "ex ante" instead of "ex post", possible "surprises" after project completion can be eliminated and there is a possibility of immediate reaction. An opportunity for improvement is the introduction of integrated project management. The integration of project controlling in the economic information system of the organisation is critical, as well as the necessity for implementing project-oriented IS/IT including project costing tools, etc.

**Decreasing the Risk of Fraudulent Behaviour**

Construction projects are characterised by the large volumes of funds involved, whereas the responsibility for these funds is often given to just a few individuals, including the project manager or the site manager.

There is a high risk of fraudulent behaviour at the expense of the project/company. There are several possible, typical, types of personal enrichment at the expense of the project, which, based on an estimate, may amount up to 5% of the total volume of construction costs, which, as compared to the aggregate margins in the industry, is not insignificant:

- **Preferential treatment of a certain supplier** – manipulation of selection procedures, falsification of the supplier's performance, etc.
- **Manipulation of material** – supply of lower quality or lower volume material than invoiced, fictional supplies, fictional statements of loss or damage of material, misappropriation of material, etc.
- **Manipulation of services** – use of external suppliers for private purposes, reporting of unperformed work, additional work, etc.

An opportunity for improvement is the setting of a hierarchy of approval processes (contracts, invoices and orders), the setting of competencies for individual levels, and the "four-eye principle". Other methods that are usual in other industries include electronic selection procedure support, electronic contract management, monitoring of changes and suitable setting of motivation systems.

**People**

In order to start a revolution in thinking and bring fundamental changes to the construction industry, it is necessary to focus on the employees. It is not only the quality of workers who have to identify with the changes and cooperate in the enforcement thereof; it is also the way they are treated. Human capital is often underestimated and regarded as a commodity instead of being treated as the most important asset of this industry.

**Conclusion**

Unlike other economic segments, the construction industry reports a long-term deficit of investments in innovation in the area of management, construction and an underinvestment with regard to IT systems and technologies. Due to the uniqueness of each project, construction companies will never be as efficient as companies with automated production. Nevertheless, an improvement, even of only several percent, brings very interesting results. Given the anticipated future development in the construction industry, those construction companies which focus on a long-term business concept and which consider investments in innovations and the efficiency increasing process their competitive advantage will find success.

*Miroslav Linhart, Deloitte*

**Practical Benefits of Lean Construction:**

- Bromley Primary School, UK:**
- 48% decrease in the time spent on preparation activities
  - Improvement in material supplies
  - Increase in process efficiency
  - Decrease in inefficiencies in sub-supplies

**Worcester Hospital – ABB, UK:**

- The end price is 10% lower than for a similar project
- 27% decrease in labour costs
- Finalisation eight weeks early
- Better evaluation of work safety at the construction site

**Key Changes in Strategy:**

- Customer focus and satisfaction
- Focus on a high-quality, loyal and motivated team of workers
- Elimination of activities with no added value
- Implementation of the lean construction concept
- Centralisation of necessary support activities
- Implementation of efficient IS/ICT solutions including project controlling instruments
- Elimination of space for non-standard conduct of employees at the expense of the project.

# Construction Industry in 2010

The period from the beginning of the year until August 2010 saw a decrease in construction. The year-on-year decrease was 9.8% (2009 = 100%), of which building construction decreased by 12.6% and heavy construction decreased by 3.8%.

The situation of businesses with 50 and more employees is characterised in the following table.

*Construction work with arm's length prices in CZK million (construction companies with 50 and more employees)*

	January-August 2010	January-August 2009	Index 2010/2009
Total construction work "S"	152 252	165 121	92.20
Total construction work "ZSV"	110 798	120 990	91.58
of which: domestic	105 906	117 688	89.99
of which: building construction	37 474	44 846	83.56
heavy construction	68 432	72 842	93.95
abroad	4 898	3 302	148.15

"S" – pursuant to supplier contracts

"ZSV" – basic construction (work performed by own workers)

The decrease in demand on the construction market has probably not yet reached its bottom. The downturn in demand in heavy construction, predominantly in transportation infrastructure where public orders play a decisive role, can be problematic, and the inclusion of the private sector in the form of PPP projects is still in its infancy. The currently discussed interruption of financing of transportation infrastructure structures in progress, such as highways or railways, can complicate the whole situation.

Nor is a significant increase in demand from the private sector and citizens for buildings to be expected soon. A long-term decrease in demand for buildings can be considered one of the significant risk factors for the construction industry, predominantly with regard to the employment rate. The residential construction segment, like the entire building segment, is also experiencing a decrease in demand.

In the first half of 2010 the construction of 14,296 flats was started which, as compared to the first half of 2009, represents a 24.2% decrease; 16,120 flats were completed, which is a 5.6% decrease (964 flats) as compared to the same period in 2009. This trend continues in the second half of the year. In the period from January to August, the number of initiated flats decreased by 22.5% and the number of completed flats decreased by 5.6%.

Currently, property developers operating in the Czech Republic have problems with obtaining financing for their projects. Banks require a high rate of pre-sold flats as a condition for granting a loan, which is very complicated given the low demand.

The economic crisis forces developers and construction companies to increase the liquidity of their assets, which limits the starting of new buildings in which funds are bound for a long-term, and supports the endeavour to release funds by completing and selling the initiated flats.

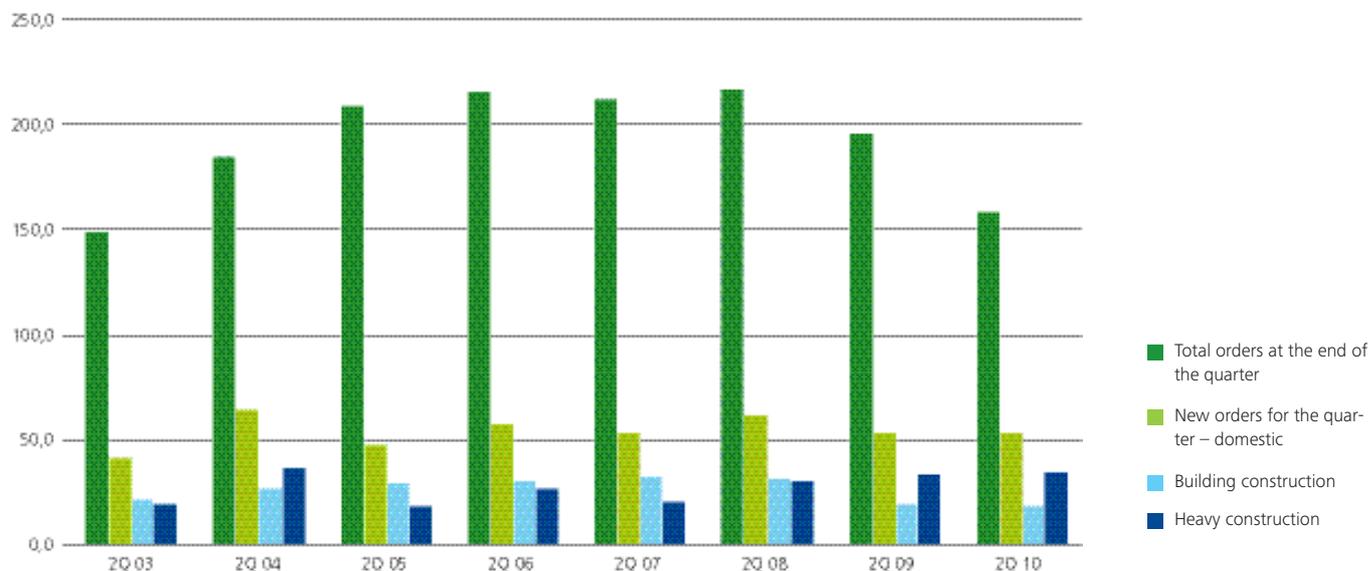
Construction companies are seeing a drop in concluded projects even in 2010. At the end of the first half of 2010, construction companies with 50 and more employees had a total of 10,600 contractually concluded projects. These projects represented an inventory of construction work that is yet to be done in the aggregate amount of CZK 158.3 billion. Of this volume, CZK 142.7 billion represented domestic projects and CZK 15.6 billion represented projects abroad.

As compared to the first half of 2009, the value of concluded projects in the first half of 2010 decreased by approximately CZK 40 billion, which represents one-month production of the construction industry. Of the total amount of domestic projects at the end of the second quarter of 2010, public orders amounted to CZK 101.4 billion and private projects amounted to CZK 41.2 billion.

Large construction companies with 500 and more employees had 60% participation in the aggregate volume of orders which were concluded by companies with 50 and more employees by the end of the second quarter of 2010.



## Development of Construction Company Orders at the End of the Quarter in CZK billion (arm's length prices)



The decrease in solicited public orders which represent more than 50% of the demand for construction also continued in 2010. As compared to the same period of 2009, the aggregate amount of solicited orders for the period from January – September 2010 decreased by 34.1%, of which 18.4% represented a decrease in building construction projects and 41.1% a decrease in heavy construction projects – of these, the amount of transportation infrastructure orders decreased by 68.1%.

Construction Segment	Jan - Sept 2010		Jan - Sept 2009		Index in %	
	Amount	CZK mil.	Amount	CZK mil.	Amount	CZK mil.
<b>BUILDING CONSTRUCTION</b>	<b>1 190</b>	<b>32 124</b>	<b>1 545</b>	<b>39 366</b>	<b>77.0</b>	<b>81.6</b>
Of which: Public buildings	1 024	28 312	1 390	36 210	73.7	78.2
Residential constructions	166	3 812	155	3 155	107.1	120.8
<b>HEAVY CONSTRUCTION</b>	<b>1 552</b>	<b>52 487</b>	<b>1 566</b>	<b>89 037</b>	<b>99.1</b>	<b>58.9</b>
Of which: Transport infrastructure	534	18 441	619	57 731	86.3	31.9
Technical infrastructure	1 018	34 046	947	31 306	107.5	108.8
<b>TOTAL</b>	<b>2 742</b>	<b>84 611</b>	<b>3 111</b>	<b>128 403</b>	<b>88.1</b>	<b>65.9</b>

Of the total of 2,742 public construction orders in the amount of CZK 84,611 million solicited in the period from January – September 2010, 471 orders in the amount of CZK 25,122 million were solicited by the government sector, 2,104 orders in the amount of CZK 49,959 million were solicited by the municipal sector and 167 orders in the aggregate amount of CZK 9,530 million were solicited by other contractors. The amount of orders solicited in the period from January – September 2010 decreased year-on-year by 58.3% in the government sector and by 21.3% in the municipal sector, and increased by 72.9% in respect of other contractors.

The proportion of the municipal sector in the aggregate amount of the contracts solicited in the first half of 2010 amounted to 59% and is double the proportion of the governmental sector which was dominant in prior years. The largest volume of orders, CZK 13,746 million representing 16.2% of the total volume of solicited orders, was contracted in the South Moravian region in the period from January – September 2010.

Public construction orders in the period from January – September 2010 were assigned to a total of 860 companies – separate entities, and 202 to contractor associations. In the period from January – September 2010, only five construction projects in the category exceeding CZK 1 billion were solicited; their total value is CZK 8,350 million and they include the St. Anne's Teaching Hospital in Brno – ICRC in the amount of CZK 2,368 million including VAT, contractor: OHL ŽS, a.s.; the construction of R6 Lubenec – Bošov in the amount of CZK 1,977 million, contractors: Association of Lubenec – Bošov, EUROVIA CS, a.s., GEOSAN GROUP, a.s. and AZ SANACE a.s.; the construction of R35 Sedlice - Opatovice, completion of the scaf-

fold bridge in the amount of CZK 1,702 million, contractor: Association of Libalova 1/2348, Skanska a.s. and Metrostav, a.s.; the construction of ČEZ Distribuce, a.s., Kletné 400/110KV in the amount of CZK 1,180 million and the construction of the educational complex of the Faculty of Electrical Engineering and Communication, Brno University of Technology, contractor: OHL ŽS, a.s., amount: CZK 1,122 million.

Of the total of 2,742 public orders amounting to CZK 84,611 million which were solicited in the period from January – September 2010, CZK 58,026 million represented 2,541 orders solicited to contractors that are separate entities, and CZK 26,585 million represented 202 orders solicited to 202 contractor associations.

The development of the demand for construction production, namely the decrease in orders from the public and private sectors for 2010 signals a decrease in construction production of 10%, a decrease in the employment rate in the construction industry and related economic sectors. This situation will not change significantly in 2011.



*Zdeněk Kunc is Director for Engineering Activity at ÚRS PRAHA a.s. who specialises in analyses, Czech construction statistics, development concepts and industry strategies.*

# “Location, Location, Location”... no more?

## Is there still room for new retail centres in Central Europe?

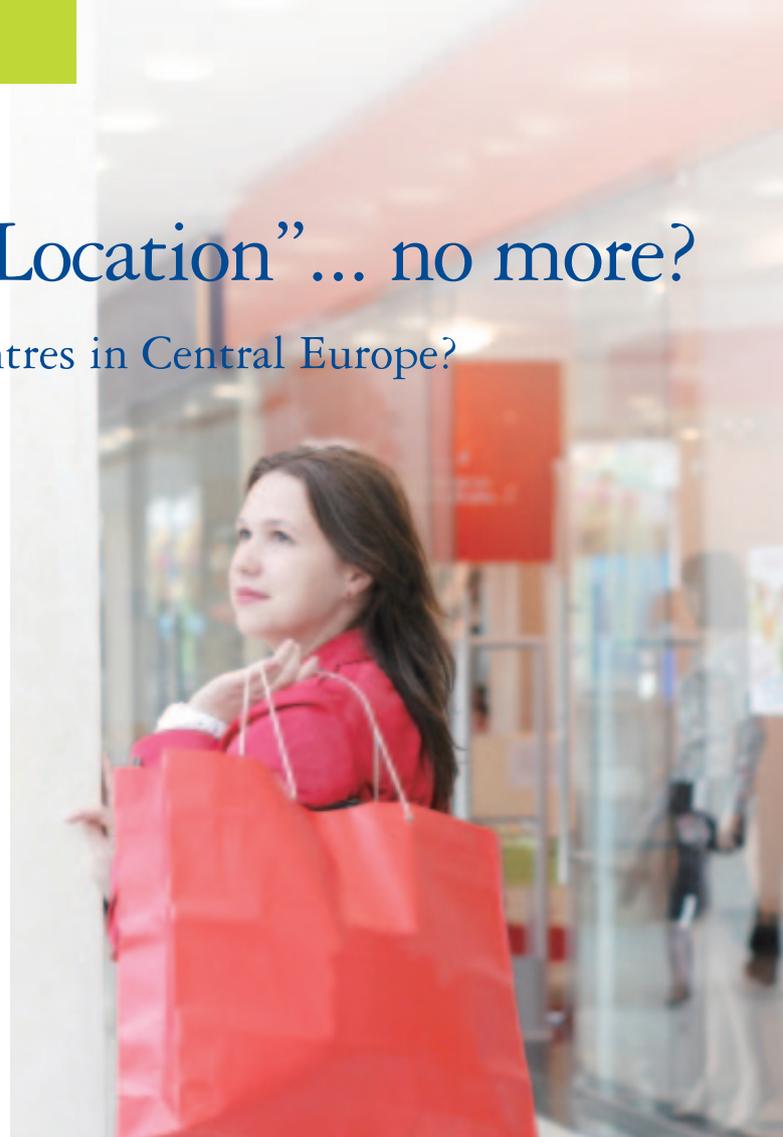
Construction company output is dependent on investor demand. In the following article we analyse the current market situation of retail centre developers and anticipated development in the near future. The impact of the financial crisis and recession caused a further slow-down in the construction of retail centres. The decrease in household consumption caused by a lower increase in real salaries, increasing unemployment and the fear of decreasing income was the most significant negative factor in the modern retail centre customer segment. The euphoria from the economic development of Central Europe resulted in an unchecked boom in modern retail centres. There was significant development of modern retail which in certain locations exceeded the usual Western European volumes.

While customers in Western Europe became accustomed to this new type of shopping including shopping centres, galleries and outlet parks over many years, Central Europe saw swift development in shopping habits in a very short time. However, the newly-built shopping centres were not always accompanied by the commensurate changes in economic growth, shopping habits, purchase prices, transportation infrastructure and urbanism. Many modern shopping centres are therefore facing an efflux of customers and lessees.

These are the basic questions regarding the development of retail in Central Europe:

1. Does the capacity of shopping centres correspond to the purchasing power in the region?
2. How many new retail areas can be absorbed by the market and what is the competition?
3. Is the location suitable?
4. What combination of business concept/philosophy and lessee structure is suitable?

The questions above result in a new concept of successful development: **responsible and sustainable development** which can be defined as a shift from single-criterion decision-making about the development and investments in real estate towards **multi-criteria decision-making**. In other words, this means a shift from the familiar motto “Location, location, location” towards the more responsible “P4 criteria” based on the English “Purchasing power, Penetration, Position, Philosophy”.



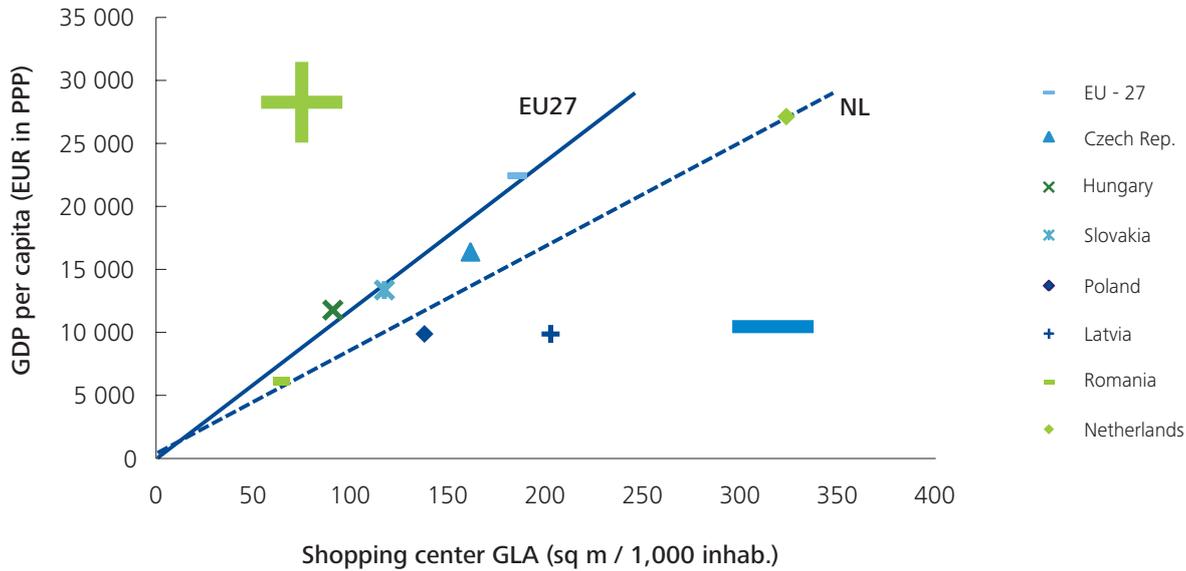
The P4 criteria is an example which shows that the times of entirely opportunistic development are over and when considering new developments or investments, it is necessary to scrutinise market, statistical and other data and try to discover the “treasures” hidden inside them.

The market data analysis cannot be reduced to just the size of retail area per thousand citizens in the region. The ability to understand the demographic, economic and specific local trends from a new perspective is becoming a significant advantage. International comparison and determination of key criteria for an analysis of data about the country/region is the new way to success. At the end of all of this there is also the approach to risk. Fear and risk is easier to overcome in a period when everyone is investing and the only question is who will be the first one and where. Investors currently face much greater fears from the realisation of a retail centre, although all criteria would be unanimously positive.

Europe is one of the most diversified regions, not only from a cultural perspective. It is therefore sometimes difficult to find the right location for retail, ie to make the right investment in retail real estate in the relevant region.

Measuring the GDP per person in relation to retail space can show us the opportunities and risks in each country and provides a deeper insight into the current market situation.

**GDP per person (in EUR) and total capacity of space for rent in shopping centres (in m<sup>2</sup>)**



Source: Deloitte, Czech Statistical Office, Czech National Bank, Cushman & Wakefield, CIA World Factbook, data from 2009.

A simple market rule that has been derived from EU 27 and Dutch markets is clear from the chart above: the total capacity of space for rent in shopping centres should equal the GDP per person. The figure and the analysis above are very general and serve for illustration only. For a decision about a particular investment a detailed awareness about the particular country and about the region, district, town or part of town where new shopping space is to be located is essential. Nevertheless, it can be deduced that retail centres in the Czech Republic have probably reached their maximum capacity in proportion to the current level of GDP per person.

Regardless, investors will continue to be interested in the retail industry. However, an essential condition is the minimisation of risks from investments and the assessment of this area must always be sophisticated and must reflect various criteria. The answer to the question of whether there is room for the development of other retail centres in Central Europe is in the implementation of responsible and sustainable development. With such an approach, investors can determine that certain regions or areas which are regarded as extraordinarily developed may bear further development, though in a completely different scheme or concept, whereas others which are considered insufficiently developed areas with high potential may be left without further interest. In the near future, the centre of focus will be the redesign and renovation of certain existing, less successful centres, rather than a new boom in shopping centres.



*Miroslav Linhart is a Senior Manager in Deloitte who specialises in audit and advisory for construction and property development companies.*



*Filip Endal is a Manager in Deloitte who specialises in advisory for construction and property development companies.*

# An Increase in Efficiency is the Only Way to Survive in the Long Run

Says Libor Joska, CEO of the Enteria, a.s. construction holding

## 1. Did the recession have an impact on your company? How do you see the development of the Czech construction industry in the near future?

The recession certainly had an impact on our company, although we barely felt its effects last year due to the one to two-year delay the construction industry has compared to the rest of the economy and thanks to the diversification of our activities. However, this year is completely different. Projects that were started earlier are being finalised and there are fewer newly concluded ones than last year. The extraordinary construction boom of the recent past has ended and will not return; that is obvious. My estimate is that the construction market will decrease by 20% on average this year. Our company is expecting a real decrease of approximately 15%. The construction capacities on the market are enormous and they will have to gradually adjust to demand. There will be several waves of layoffs. Moreover, the unused technology and advanced modern technologies acquired in the past are costly. Many companies will therefore probably have to terminate their activities. This does not have to come all at once; it may take one or two years and over this period the situation in the construction industry will not be good. It is necessary to realise that it is not only demand that is decreasing but also competitive prices. Thus the combination of the decrease in the scope of the construction industry and the decrease in the prices for construction work could result in a market decrease amounting up to a half of the 2009 figures. The pressure on prices is currently enormous and investors are basically not interested in anything else at this moment, which is not good. A single-criterion evaluation of projects is bad from a long-term perspective and investors will feel it after some time. Unfortunately this also affects the development and existence of many construction companies, as well as our entire economy. In our opinion, good resource management is more reasonable and efficient than rash saving. It will definitely be very important what direction is set by the new government as well as what the approach to public investments and the support of private investments will be. We understand that savings are necessary in the current situation and that many things need to be rationalised; however, this is not always easy if you are responsible for 800 people who need to work. A concept must be developed and investments must be purposeful.

## 2. Have you learnt from the current development? Have you made or are you preparing to make any measures related to the decrease in demand in the industry?

The construction industry has still not faced the real crisis; we will see how long it takes. In a number of companies, "cross-financing" is still working, i.e. new projects that are often offered for a price that is lower than the costs are financed from previous projects which still had a certain margin. However, this situation cannot last long. It is uncharted territory for everyone and we are trying to find our way and the right strategy, and we have to do it now. We will have to cope with the fact that there are excessive production capacities on the market and the price level is significantly dropping. For example, a Škoda Octavia used to cost CZK 600 thousand, but due to the recession the price sank to CZK 450 thousand and I have not heard anyone publicly saying that Mladá Boleslav was robbing them. Yet, we often hear this in the construction industry. However, it is most often not about construction companies having high margins in the past; it is about

living in the market economy. Two years ago, the prices for construction work were 20% higher. Today they are lower and, moreover, we are facing the absurd price war between construction companies, which results in a price decrease by another eg 20% below cost and that is not sustainable on a long-term basis and will be reflected in the entire economy. Everything will gradually return to normal, as there will be fewer older projects that have been concluded for better prices and less construction capacities in the Czech Republic, and the companies will cope with the demand for construction work. We are working with this vision and anticipated development, we are thinking about it, changing and putting something together and we have prepared a plan and a strategy for 2011. The first phase is of course cost-cutting and pursuit of maximum efficiency. When a crisis comes, you scrutinise costs more thoroughly and look for all your reserves. But we are trying to be reasonable, predominantly with regard to our employees; we are not extreme. In 16 years we have developed a corporate culture which we cannot and do not want to throw away due to savings. We believe that the company is based on the long-term cooperation of people and their loyalty. There are huge reserves in the organisation of work, in preparation and planning and the internal functioning of the firm. The current situation places higher demands on people and puts the quality level higher. We are trying to evaluate the employees from the perspective of their potential to adjust to this new performance level.

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The pressure on prices is currently enormous and investors are basically not interested in anything else at this moment, which is not good.

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We are betting a lot on our choice of people, the ones who have to fit to our corporate culture so that we do not destroy our well-functioning system. Nevertheless, our decrease in staff does not equal to the proportional decrease in demand. In order to be able to provide quality to our customers and maintain our market share, we unfortunately have to maintain quality and experienced staff at a higher level at the expense of short-term losses. A new war has begun on the market. And if you want to win, you cannot dismiss all of your generals and soldiers.

## 3. How do you increase your company's efficiency? How much room do you give to the implementation of innovations?

You need to invest in the increase in efficiency, innovations and an ongoing development of staff. That is not for free. However, the current development is against it – how do you want to invest in the times of crisis? Despite that, the increase in efficiency and ongoing innovations are a necessity and the only way to survive in the long run. Fortunately, we made the majority of the crucial investments before the crisis came and therefore certain rationalisation steps will hopefully make our survival during the crisis easier. Each person in the organisation has their tasks and, same as a businessman who has to achieve the maximum price possible, which is however more or less prescribed by the market, the people who are responsible for



*Libor Joska is the CEO of the Enteria construction holding which was founded in May 2008 as an administration, management and service element of a group of Czech construction companies with the aim to ensure their more efficient functioning. Currently, Enteria includes eight companies, predominantly construction companies, with nearly 800 employees and a production potential of CZK 3-4 billion.*

production must continually think of how to minimise costs and maintain quality and the added value for the customer. Our company functions on the basis of the lean principle, ie we only keep staff that we really need, we do things that make sense and bring value.

#### **4. What use does your company make of information systems and technologies?**

Together with the company's growth and the effort to increase efficiency, the demand for quality information is also increasing. We were considering a comprehensive system which will connect everything, ie the firm's finances as well as the overview of projects and legislation. Unfortunately, we discovered that the large, most commonly used information systems cannot do what we need for the management of a construction company; the majority of these firms have minimum experience with the construction industry. We further discovered how difficult it is to define what such a system should look like. It was a complicated and expensive process; nevertheless, this system currently speeds up and simplifies our work, predominantly thanks to the reliability of data and the possibility of quick decisions. The key data is available immediately, before it is too late.

#### **5. Do you think that there will be a consolidation of construction companies on the Czech market?**

The main consolidation wave is already over and the market is exhausted at the moment, and so foreign companies would rather look farther to the east. Capacities will definitely be adjusted to match demand and the market will be "cleared" naturally. It is not worth buying a firm which has no market especially when own capacities can be used. Moreover, it is necessary to retain the variability in the market; big companies have to be complemented by mid-sized and small ones. This should be in everyone's interest.

#### **6. What in your opinion makes a construction company valuable?**

First of all, it is high-quality, loyal staff which acts as one, from management to the site worker. It is about the corporate culture, how it works, what relationships have been set, if there is trust and good interpersonal relationships. Moreover, it is also a functioning and efficient system of corporate management, production and quality information systems. This is all that holds a firm together and makes it a living thing. "Unfortunately" also money without which it would not work. Money must not be in first place though.

#### **7. What characteristics do you think a construction company should have in order to be successful nowadays?**

It is again a high-quality and motivated team. Not everyone has to be a champion but they have to complement each other and be well coordinated. There must be mutual trust between the firm and its employees

who are then able to shift the firm somewhere and the firm rewards them in exchange. It is certainly necessary to have a history and references, some experience and access to funds if possible. And also a strategy – either to be universal and big and be able to offer everything in high quality, or to specialise in a certain area and be easily identifiable on the market.

#### **8. Lately, the payment of invoices has been prolonging critically. How would you evaluate the situation and how do you solve it?**

It is a big problem. Many firms are doing it to solve the refinancing of their activities. Sometimes the same situation occurs with the state. If the state does not observe the conditions, others have the feeling they do not have to either. If receivables represent more than one third of your turnover, you are logically in big trouble. A loan can be used for refinancing only to a certain extent, and the settlement of payables is unfortunately also partly delayed. As soon as your customer pays you, you send the money to your suppliers.

#### **9. What is your opinion on PPP projects? Do you think they are the future of the Czech construction industry?**

It is certainly one of the possible ways of future development. Another thing is that no one in the Czech Republic can probably follow things through to a successful end. There have been several attempts which did not end well (eg D47), on the side of the state as well as on the side of potential investors. There is unfortunately no clear vision and concept of how these projects should work. Moreover, the principles of PPP projects are often distorted by the media and the public does not know what they are. It seems that the state is probably unable to accept a certain risk. It has to start with small projects. If you want to play tennis and you have all prerequisites for it, you have to throw yourself into it and train hard. You will not win Wimbledon at first but you have to try.

#### **10. What should be the role of the state in the support of the construction industry?**

It would be ideal if the role of the state was minimal, since the state is usually a bad manager. Unfortunately, in the transportation infrastructure it will always be the state and its influence will thus be significant. The state wants to save at any price, but still be a good manager. It should have a goal and a system so that the structures would have the highest possible quality and last as long as possible, which, however, costs something. The state should gather maximum resources and use them efficiently. From the construction perspective there are many possibilities, it is only about undertaking something. Let's learn it from other countries where this works – be it the discussed PPP projects or the concepts based on close cooperation of the investor, designer, construction company, construction supervision and other interested parties from the beginning of the project with the motivation of achieving maximum savings for the investor. The state should have a clear concept of what it wants to build and how to finance it, and at the same time it should be interested in retaining sufficiently qualified building capacity which it should help at the level of financing guarantees and at the level of clear and stable legislation.

#### **11. Do you think that the arrival of foreign competitors on the Czech market is realistic, eg the arrival of the Chinese construction giant COVEC (China Overseas Engineering Group Company) in Poland?**

I honestly think that it is nonsense and I believe that the discussions of this topic were not meant seriously. I would understand it in a situation when there would be a catastrophic lack of capacity on the market but not in a situation where there is a significant excess. As a society we should primarily focus on where to create and what to create, and what will be the source of our growth in the future, not on what to eliminate and cancel. We also have to think about the income part of the budget where the construction industry has a significant role.

# Accounting Aspects of Associations

The realisation of construction projects in associations has been a common trend recently. An association of two or more partners can bring technical and technological advantages, volume savings or higher gains arising from the application of specific know-how. However, the existence of associations can sometimes be solely purpose-oriented, with the aim to fulfil the formal conditions of a tender.

Please bear in mind that pursuant to Czech legislation, an association has no tax and legal subjectivity; it is embedded in the Civil Code, it is not recorded separately in the Commercial Register. The leader, who also pays the association's statutory taxes, acts on behalf of the association.

When associations are formed, it is necessary that the partners communicate with each other and are able to agree on the most important aspects of its functioning. These predominantly include the appointment of an association leader, determination of the form of association, division of the volume of work, determination of how the association members' will act in internal matters and with external partners and the setting of accounting document flow. The association contract should cover all these aspects. Our article focuses on the accounting level of a construction association with regard to the conditions in the Czech Republic.

From the beginning, accounting and financial reporting are predominantly influenced by the selected association form. In practice, two basic association forms, ie the horizontal and the vertical, are modified with regard to the needs of the project, of the association members and also with regard to the character and strength of individual association members.

- *In a horizontal association, the association members usually act together in dealings with the investor, they have equal positions, and the leading participant is usually responsible for the accounting and carries out the entire administration, review and coordination of the association's activities. The participants have a determined portion of the work which corresponds to their share in the association, they work on this portion independently and generate profit/incur loss on it based on the efficiency of their work. In addition, they participate in the settlement of common costs of the association.*
- *Conversely, in a vertical association the subsidiary participant has a role similar to a standard sub-supplier. He de facto transfers his determined portion of work to the main participant who primarily deals with the investor. Any additional requirements for the investor are communicated via the main participant.*

The Czech accounting legislation does not include much information on the accounting and reporting of associations. The obligation to maintain accounting of the association is included in the Accounting Act with reference to its participants.

However, no detailed rules for maintaining accounting and reporting are available in the legislation. This legislative insufficiency can lead to certain anarchy in practice, where the leading association participant reports inflated costs and income or presents the items of assets and liabilities in the balance sheet which do not fully pertain to this participant. There are usually no complications in the case of the subordinate participant.

- *For illustration, imagine a situation when both participants make an initial deposit of CZK 30 million into the association. The leading participant who maintains the bookkeeping of the association will record the association's bank account with the CZK 60 million in his books (CZK 30 million will flow from his own bank account), at the same time, he will record the association's payable to its participants – based on how the intracompany accounting is established, this might only amount to CZK 30 million (corresponding to the funds deposited by the subordinate participant) but may also amount to CZK 60 million. All in all, the main participant presents funds in the amount of CZK 60 million in the balance sheet which he cannot use freely, he can only use them for the purposes of the association's payments. If the leading participant himself used eg funds from the overdraft account, loan or borrowing, the situation is even more bizarre.*
- *In the case of recording the expenses and income of the association, we can easily find out what variable accounting practices are used. The construction work carried out by the subordinate association participant is usually recorded as a sub-supply in the accounting of the association maintained by the leading participant, which is rather direct and logical. This is much more complicated in the case of the leading participant.*

The leading participant incurs "primary" costs in the primary sphere – consumption of material, sub-supplies, other services, salaries and write-offs. If the leading participant invoices this work on behalf of the association, the accounting of which he also maintains, he in a way invoices on behalf of himself. The question is the accounting representation. Will he present inflated income and expenses in his financial statements, ie his own primary expenses and of these expenses rebilled to the association? Or will he reflect the performed work in expenses and income only once (will the invoicing to the association be reflected in intracompany accounting)?

## Taxation of Czech Qualified Investor Funds



*Miroslav Zigáček a Manager in Deloitte who specialises in audit and advisory for construction and property development companies.*

The size of the business measured by the performance volume can thus appear completely different.

Various charts are prepared based on the performance volume, the size of the company is assessed according to them but they also serve for other purposes, such as for negotiations about bank loans, which should provide the accounting reports user with the opportunity to assess the accounting policies of the relevant company and draw important conclusions from them.

Thus, in the notes to the financial statements construction companies should include how they record associations in which they participate separately by whether they act as the leading or subordinate association member. This is a necessary prerequisite for the fulfilment of the highest requirement of the Czech legislation on financial statements, ie the requirement of a true and fair presentation, based on Section 7 of the Accounting Act. The requirement for publishing the significant accounting policies is also explicitly stated in the executive regulation to the Accounting Act, Section 39.

In conclusion, it can be summarised that the non-existence of clear accounting methods for the accounting of transactions carried out as part of an association's business also brings practical problems and can have quite a significant impact on the quality of published information about the performance of construction companies. Therefore, the primary (concept) rules of our accounting legislation should be observed in practice, namely the requirement for a true and fair presentation of the financial statements which also includes the requirement for the presentation of the used accounting methods and policies. In such cases, consulting with an audit/advisory company is an advantage.

**Miroslav Zigáček**  
Manager Deloitte

Czech collective investment funds have a generally more beneficial tax regime, in particular the corporate income tax rate has been decreased to 5% (as compared to the standard 19% rate). The beneficial tax regime is applicable for various types of investment, mutual and pension funds.

A specific group of funds are "qualified investor funds" which, as a rule, offer the lowest level of regulation of all types of collective investment funds available in the Czech Republic. From the legal perspective, qualified investor funds can have two basic forms – an investment fund in the form of a joint stock company (separate legal entity) or a mutual fund without legal personality which is fully managed by an investment company. The minimum investment of each investor in both these forms is CZK 1 million (approximately EUR 40,000). From the tax planning perspective it should be emphasised that qualified investor funds in the form of a joint stock company are entitled to use the advantages arising from double taxation treaties and the EU directive on parent companies and their subsidiaries during the distribution of dividends. In certain cases, it is also possible to acquire assets for this type of fund through merger or non-cash asset investments.

The Ministry of Finance has recently been considering the tightening of the above-mentioned beneficial tax regime which would in principle result in the elimination of certain groups of qualified investor funds (bases on the structure of investors and the method of acquiring assets) from the beneficial tax regime. This change should have been included in the latest amendment to the Income Taxes Act, but in the end it was not. On the other hand, the above-mentioned government amendment to the Income Taxes Act explicitly determines that the beneficial 5% tax rate should also be applicable to similar collective investment funds based in other EU states.

Currently, the government is preparing an amendment to legal regulations which modifies collective investments, including qualified investor funds. In addition to imposing other statutory and reporting obligations on the collective investment funds, this amendment explicitly determines the obligatory existence of at least two shareholders. A significant change will, without doubt, be the newly introduced possibility of changing a qualified investor fund into a common joint stock company, based on the decision of the general meeting adopted by all shareholders and the cancellation of the licence by the Czech National Bank based on the request of the relevant fund. However, the qualified investor fund can make such changes no sooner than after six years of existence.

Czech qualified investor funds are therefore still attractive from the tax perspective. Moreover, similar EU funds can currently be used for the purposes of structuring investments in Czech real estate since they should have the possibility of profiting from the beneficial tax regime in the Czech Republic, ie the same as Czech collective investment funds. Nevertheless, the implementation of certain tax benefit restrictions for qualified investor funds can be expected in the future as part of the planned new Income Taxes Act.

# A Quality Budget Is Essential

Financing, costs, prices – these are some of the most commonly discussed topics in all areas of the public and private sectors. Significant emphasis is put on decreasing the state budget and areas for saving are highly sought after. As such, these matters not only have a substantial impact on firms seeking public contracts, but also on medium and small entrepreneurs and also on ordinary people.

With a slight delay, the economic crisis has recently fully struck the construction industry. The impact of the crisis seems even more dramatic if we look back on the period between 2005-2008 in which the revenues of the construction industry were growing, and there was no lack of orders. These phenomena inevitably affected the market prices of construction work. The property development industry did not suffer from a lack of funding and the increasing volumes of construction enabled the entrance of a wide range of new construction and engineering firms which had acceptable levels of orders. As a result, a complex and layered system of subcontractor relations evolved within the construction industry. In addition, many times its goal was simply revenues rather than production. The bid prices in that period were often based on market mechanisms rather than on the cost (ie calculation-based) method commonly applied at other times. As such, how much a developer was willing to pay was more decisive than much the relevant structure would cost to build. However, this situation has now radically changed and the increasing pressure on decreasing the prices of construction work leads to more diligent cost reporting and making budgets under work contracts clearer and more detailed.

In customer-supplier relationships the world over, one rule is valid: the supplier (regardless of whether a hairdresser, a tin-smith or a construction company) usually has a precise idea about the price which he expects the customer to pay for the provision of a product or service, in order to settle his costs or fulfil his needs. On the other hand, the customer (developer) is in a far more complicated situation, as he can frequently only orientate based on the publically known prices, either on the basis of his own experience or in comparison with competitors' offerings or a public price list. When applied within the construction industry, this premise puts a significant emphasis on the necessity to have at least basic knowledge of price calculations and budgeting. In addition, when negotiating the prices of construction work (the technical complexity and volume of funding of which is usually greater than in other industries) there is a necessity for developers to prevent overpayments for construction work or, conversely, not to have inappropriate requirements from suppliers which they cannot objectively meet or which may negatively impact the parameters of the supply.

In general, the developer has a preliminary (project) budget prepared for him based on which the supplier of the construction work usually prepares the bid (marketing) calculation. Both contractual parties try to set the most precise total price of the construction. Principally, the total price includes individual prices of structures and construction work (which can be explicitly measured and reviewed based on project documentation), which are usually part of the budgets for buildings representing basic budget costs and including particular prices of basic input materials, such as, product and building materials prices and the processing costs (ie payroll, machinery, etc).

When setting out the total price of a structure, the types of costs are included in the final price which are more related to the organisation of the construction work, ie efficient management of resources and other costs related to the allocation and operation of the structure rather than the costs related to structure components and construction activities as such. These so-called additional costs are related to a particular structure, a particular supplier of construction work, sub-supplier relationships and multiple additional components. Another important part of the total price of a structure includes the costs of design, engineering, revision and completion activities. Compared to the first group of costs, the remaining two cost groups are difficult to measure and are usually handled under individual contracts or they are delivered by multiple individual entities. In respect of large-scale contracts (ie usually directly or indirectly funded by the state), these activities can significantly influence the total price of the project.

The area of calculations and budgeting is a rather sophisticated one and, principally developers are seeking its maximum simplification. Based on various reasons (either due to sheer ignorance, unwillingness to learn or due to the effort to import international/European models at any cost) a wide range of budget types arise which have one thing in common: they attempt to create a simple matrix for buildings including volume (numbers) and prices per unit relating to buildings (in respect of which all expected realisation costs are calculated). Such a solution has many advantages, as the simple matrix enables evaluating a tender, revising completed production or preparing invoices, etc in an easy way. However, this is easily applied only until disputes or problems arise (such as valuation of extra work, interruption of construction work, the necessity to value work in progress, etc). So far many organisations have had a negative experience after determining that the costs of some already built structures do not interrelate with the actual incurring of other types of costs; or that a seemingly simple matrix provided by an international/European system is based on complex and, more importantly, binding documentation which specifies the parameters of the relevant structure and the methods of construction.

There are many different ways and tools for providing more or less detailed segmentation of a project. In addition, a budget, either simple or complex, can be prepared by any construction supplier or an experienced budgeter. However, if the budget is to serve as a communication tool, there must also exist a set of rules which define how the budget was prepared. This is because the budget does not represent the actual price for a unit in a stage of construction (design, construction, location etc), but it represents an agreement on what the particular price shall include and whether the included costs are directly interconnected with the relevant segment.



If budgets prepared based on underlying budgeting documentation (ie particular agreed systems or price groups) are to meet their basic functional requirement, ie to be an efficient and transparent communication medium within supplier-customer relations, they must meet certain basic rules. However, the rules, such as follows, are often forgotten or intentionally ignored:

- The amount of detail in project documentation must equal the amount of detail in the applied budgeting documentation.
- The classification and price of budgeted items must correspond with their scope and method of application in the above-mentioned budgeting documentation.
- The method of calculating the number of items must comply with the measurement methods outlined in the budgeting documentation.
- The price of individual items must adhere to the cost structure included in the budgeting documentation.
- Individual budgeting systems may not be mutually combined.
- The form of the budget output must have relevant (ie agreed) parameters.

If the savings efforts are to be really efficient, it is necessary to know, review and verify the scope of prices which are included in construction budgets. The suppliers' knowledge is naturally expected, as when making an offer, a supplier assumes the risk of financial loss which may arise if he underestimates any of the relevant issues. On the other hand, developers have to accept the fact that excessive simplification or inconsistency in the structuring and review of costs from a project's

very start may later cause unexpected problems. Even though a work contract includes an agreement on a fixed price, it does not necessarily provide certainty that the price of the construction work shall not increase in the course of the project's realisation. Thus, the "trust but verify" rule of thumb is inevitably valid for all business relations including the construction sector.

Luckily, we do not have to search long for help, as in the Czech Republic there is an advanced time-proven budgeting system in place. This system is even more advanced than those seen in a wide range of (even developed) European countries. The system not only includes a precisely defined structure (class and code lists) which enable structuring the budget by individual cost types, but it also includes a comprehensive set of descriptions and methodological instructions which clearly define individual structure segments (eg design or work) and the method by which these are to be included in the budget. Apart from the fact that this budgeting system is the only one used on a national level, it also provides an overview of illustrative prices including the transparent manner of their setting and method of use.



*Michal Hanák is a Production Manager in ÚRS PRAHA, a.s. responsible for a wide range of documents supporting the valuation of construction output in the Czech Republic and the development of the valuation system of CS ÚR.*

# Contacts

Miroslav Linhart, Deloitte  
mlinhart@deloittece.com

Filip Endal, Deloitte  
fendal@deloittece.com

Václav Matyáš, SPS Czech Republic  
matyas@sps.cz

Miloslav Mašek, SPS Czech Republic  
masek@sps.cz

Zdeněk Kunc, ÚRS Praha  
kunc@urspraha.cz

František Glazar, ÚRS Praha  
glazar@urspraha.cz

