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Tips to Measure and Maximize Cash Flow in Construction Businesses

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Published On: Monday, February 13, 2017 10:42 AM

A contracting business is a living, breathing organism that needs to be fed. If unhealthy, that organism will put tight constraints on a contractor's ability not only to grow, but also to make payroll and fund projects. When nurtured properly, the business will flourish, minimizing stress in an inherently high-stress industry.

The necessary nourishment is cash, and cash flow is the lifeline of any contractor. Many contractors feel that growth is the primary measure of success. However, positive cash flow is a better, and more challenging, measure of success—and it's essential to a company's ability to grow.

Following are accounting tools and concepts that help contractors measure and maximize cash flow.

Understand Cash Flow

The theory of positive cash flow is very simple: Cash receipts lead to cash payments. However, if achieving positive cash flow is that simple, why do so many contractors fail? The old saying "what you don't know can hurt you" applies here.

COMMON CONTRACTOR CASH FLOW ISSUES		
Retainage	Uninstalled materials/overstocked inventory	High liquidated damages
Change orders/claims	Poor internal billing practices	Overbillings spent on "unnecessary" items
Poor collection controls	Labor-intensive work	Tax liabilities

Small contractors are often led by owners and managers who have limited accounting knowledge and small accounting departments, resulting in missed opportunities to maximize working capital through advantageous tax strategies. Larger contractors have stronger back offices, but face challenges of communication between departments, often leading to internal delays in billing, inability to track and bill for change orders, or collection issues on projects or with customers.

In a lot of cases, these common issues are picked up rather late in a project, making it difficult to recover or limiting the options available to remedy the situation. Timely review of a contractor's financial information, including key ratios and project status reports, can provide a significant amount of information early, allowing enough time for proper decision-making.

Some key financial indicators include the following.

Underbillings: Usually a Bad Asset

Underbillings, which represent the contractor's deficiency in billing as compared to revenue earned on a contract, can be a contractor's worst nightmare. Most of the time, underbillings indicate poor billing procedures, in which documentation isn't being received in a timely manner from the field, requisitions are not getting approved on a timely basis for final submission, issues exist with unapproved change orders or unrecognized profit fades.

This results in the contractor funding the job, increasing the use of financing tools (i.e., working lines of credit, owner contributions or advances, receivable factoring) to obtain the funds to satisfy cash requirements, which can overextend the contractor. Tracking the overbilling and underbilling status in a timely manner on a job-by-job basis can help catch these issues early.

Overbilled: Show Me the Money

Overbillings represent the contractor's ability to bill ahead of a contract's percentage of completion. In most cases, this is a positive practice, as the contractor is using the customer's money to fund the project. Where contractors fail in this scenario is when the excess cash in the bank is not earmarked to fund future project costs.

Contractors who spend the excess cash to purchase non-project related items (i.e., payments to owners, cars, equipment, etc.) will create a cash deficit as projects are completed. If the contract is overbilled, the funds should be held until the completion of the project. Monitoring project and company cash flows on a timely basis will help reduce project completion cash flow deficits.

Eliminate Tax Surprises

Proper tax planning will create deferral opportunities, which will eliminate surprises come tax time. Hefty tax payments, whether on a company or owner level, can be a detriment to a company's cash flow position, especially in down periods when cash is needed to start up projects.

Having a strong accounting department, or partnerships with accountants who have strong construction experience, can help defer tax payments in order to free cash for project completion or growth.

Financial Ratios Tell the Story

Financial statements are more than just numbers; they tell a story about the job. Reading key ratios can help identify significant issues early, enabling contractors to remedy potentially negative situations before they do real damage.

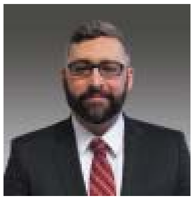
Following are common financial ratios:

Days Sales Outstanding ("DSO")	A measure of the average number of days it takes a contractor to collect a receivable. Average DSO for contractors is 60 to 70 days, but with proper controls and communications, ideal collection should be 40 days.
Accounts Receivable Turnover	The quicker receivables turnover the better. A major red flag for a surety is slow-turning receivables. Sureties will always question a contractor with 90-day and older aged receivables, especially if there is a pattern.
Retainage Balances	High retainage balances may reflect a contractor's inability to close jobs and get final paperwork filed. Additionally, having lower retainage percentages or negotiating the release of retainage as the contract progresses will increase cash flows to fund the project. Sureties will want to assess how a contract with high retainage rates will be able to fund the project.
Working Capital	Working capital is current assets minus current liabilities, measuring funds available after meeting current financial obligations.
Debt-to-Equity Ratio	Debt-to-equity ratio is determined by dividing total liabilities by owners' equity. This measures how much of the business is funded by the owners versus creditors. A debt-to-equity ratio above 2.5 will raise eyebrows in the lending and surety community.
Project Gain (Fade)	Timely review of contract estimates will identify cost overruns or delays, which will enable the contractor to identify opportunities for change orders.

Spend Money to Make Money

To properly manage cash flows, a contractor must invest in the proper infrastructure internally. This starts with the systems (including accounting, project, etc.) that will produce accurate and timely information, surrounded by strong internal controls that promote timely communication. Proper communication between project management and the accounting department will help streamline billing and change order practices.

Finally, contractors should surround themselves with experienced professionals with strong construction expertise. This includes sureties, bankers, attorneys and accountants who understand the construction industry and can help the contractor identify potential problems before they become critical issues.



William Simon is a member of Marcum LLP's national Construction Industry Practice group. Marcum provides audit, consulting and taxation services to construction clients ranging from start-ups to multi-billion-dollar enterprises. The group's professionals, among the country's foremost experts in construction accounting, are frequent industry authors and speakers and also serve as technical reviewers for the AICPA's construction audit and taxation guides. The group publishes the quarterly Marcum Commercial Construction Index and the annual Marcum JOLT Survey Analysis, a discussion of employment trends in the construction industry. For more information, visit http://www.marcumllp.com.

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