



ILLUSTRATION BY JOHNNY BORK

# CASH

Completing jobs is the easy part, it's cash flow strategies that will make or break a contracting business

# The **LIFEBLOOD** of the Contractor

BY ANTHONY R. STAGLIANO



**M**ake no mistake about it: Cash continues to be the lifeblood that runs through the veins of every construction company. Unfortunately, many contractors are more comfortable bidding on jobs (and dealing with problems and technical matters in the field) than collecting the money they are owed.

However, the ability to find and maintain a positive cash flow remains at the heart of the most successful contractors. It's a fatal fact of life that more contractors go out of business because of a lack of cash flow than a lack of backlog or profit. Contractors do not have to be in business to make money, but they do have to make money in order to stay in business.

Cash flow management actually starts when contractors decide to bid on a job. Many contractors are more interested in submitting the lowest successful bid than in the importance of cash. However, their joy can be short-lived, especially if they have "left too much on the table."

So, when making that important decision about whether or not to bid on a job, realistically address the following questions: How busy will the company be when given notice to proceed? Has the company been success-

ful with this type of contract in the past? Is the job's location feasible? What is the possible impact of seasonal weather conditions? Are there any unusual contract clauses that could negatively affect cash flow?

In addition, carefully review the customer's past payment practices for instances of over-inspection, improper or excessive back charges, and significant reductions in payment requests. If the payment history is too questionable, it's not prudent to bid the job.

#### **Preventive Care: Contract Terms**

If the decision is made to bid on a job, remember that because profit ultimately turns into cash flow, the margin or reward must justify the risk. Therefore, negotiate best payment terms before – not after – the contract is awarded.

Every contractor should seek to modify or eliminate contract retainage terms. For example, if a contract states that the standard 10 per cent will be withheld, then negotiate for a reduction to at least five per cent when the contract is 50 per cent complete. As the contract approaches 75 to 80 per cent completion, the retainage should be further reduced to two per cent or less.

Withholding 10 per cent retainage until the end of a contract creates a serious drain on cash flow. And, a severe drain or loss

of cash (the "blood" of a business) can kill a company, just as excessive blood loss can kill a person.

In 2007, the Construction Financial Management Association's annual financial survey reported that the average net earnings before income taxes (net margin) for all types of contractors is 2.7 per cent. It's no coincidence that best in class contractors reported a net margin of 8.1 per cent.

For a contractor who performs work in the early stages of a project, the longer the retainage is held, the greater the probability of a cash flow problem. To speed up collection of the remaining retainage, all punch list items should be completed as soon as possible. If not monitored carefully, the last 10 per cent of a job can take 20 per cent of its cost to finish. The best companies in the business are known as "closers."

#### **Daily Exercise: The Collections Policy**

It's a well-known fact that contractors face unique problems and issues when it comes to collecting their money. These include: retainage, pay-when-paid clauses, pay-if-paid clauses, right to stop work, back charges, approval of change orders, front-end loading, partial payments, mobilization, stored materials, claims, lien rights and disputes.

Given this context, your corporate culture

must reinforce your company's right (not privilege) to collect owed money. Adopt a proactive attitude about collecting cash, and don't be afraid to spread the word to your customers. Make collections a daily process. Eliminate those end-of-month panic attacks where a lack of cash starts to drain the life out of your company.

Keep in mind the old saying, "The squeaky wheel gets the grease." Call early and often, and encourage everyone in your finance department to bill on time for the total amount owed. Bill aggressively, and don't be ashamed to use a reasonable amount of front-end loading. Remember, it's just good business practice.

#### Regular Followup: Billing

Knowing each contract's billing terms – including the timing for submission of billing, the approval process and the contact person – is a must. Always deliver the first invoice in person as well as subsequent large invoices. Also, pick up checks to help eliminate delays and excuses.

After the initial meeting, do not wait until payments are past due to call again. Contact the controller seven to 10 days before payment is expected to confirm that everything is on schedule for timely payments, and ask if there are any questions or problems.

If you wait until your payment is past due, you may have missed your customers' billing cycle for the next month and your second invoice might be incorrect and, therefore, also delayed.

#### Change Orders: A Prescription

Profit fade and cash flow drain also result from the improper handling of change orders. It's imperative that everyone on the job, especially your project management team (including PMs, superintendents, foremen, etc.), knows about work outside the original contract's scope and communicates this information daily so that proper change orders can be issued.

Written documentation through field change orders signed by the customers' authorized representative – as well as job diaries, meeting minutes, and digital photos – are excellent tools for substantiating your compa-

ny's right to additional compensation.

Also, monitor changes in on-site conditions, accelerations of work, unusual weather conditions, stacking of trades or out-of-sequence work. Whenever possible, use your leverage to have these change orders signed, especially when customers need your help to meet their goals.

#### Elective Procedures: Other Cash Management Techniques

Contractors must keep a tight grip on cash flow at all times to survive construction's

arrive late in the week.

2. Use specialized accounts to maximize cash flow. A controlled disbursement account with a bank in another remote location can increase the float on checks from one to three days. Zero-balance accounts employ a central bank account and a number of separate accounts (like payroll) with no balances. The separate accounts receive only enough funds from the central account to cover the checks presented. This makes larger balances available on checks that clear the bank.

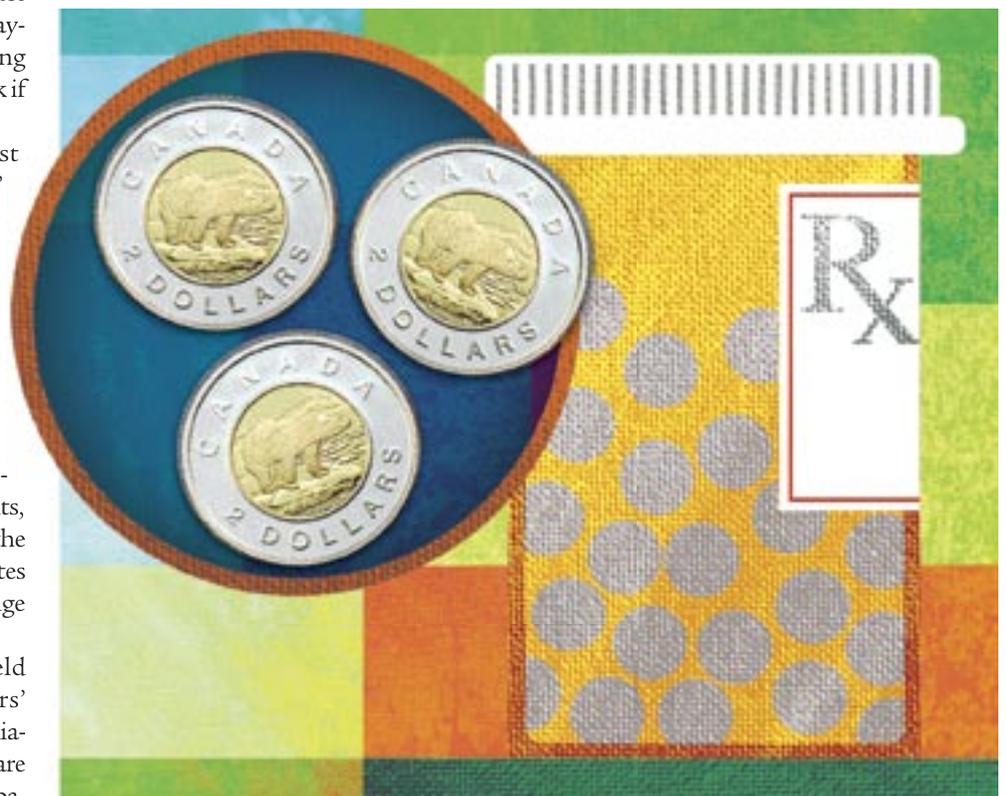
3. Invest excess or idle funds. This is a goal every contractor should strive to achieve. Some common investment

vehicles include: certificates of deposit, government securities, commercial paper, bankers acceptances, repurchase agreements, tax-exempt funds, mutual funds and bonds. However, if a company has a line of credit with an outstanding balance, first sweep available excess daily funds against the outstanding balance. This will result in net inter-

**It's a fatal fact of life that more contractors go out of business because of a lack of cash flow than a lack of backlog or profit.**

volatile and high risk environment. So consider these additional cash management techniques:

1. Mail checks as late as possible (but still keep within payment terms) to maximize the use of cash for investment activities. To create the most cash float for balances over the weekend, mail or deliver checks so they



est income because the interest rate earned on short-term investments is usually lower than the interest paid on a line of credit.

**4.** Make remote cheque deposits. Due to a relatively new banking service, you can now scan and transmit critical daily deposits within minutes. Using this service will put your money to work faster, with the added bonuses of increased security and higher collection rates. Electronic deposits can be made outside traditional banking hours, and physical cheques are no longer required by most banks. In addition, accelerating deposits can mean significantly more net interest income earned. You can also shred these cheques at the end of your bank's recommending holding period.

#### **Triage: Expensive Sources of Cash**

Other auxiliary sources of cash include the infusion of additional equity or loans by shareholders. The primary problem with this alternative is an owner's ability to infuse after-tax cash into the company. A second source is borrowed money, primarily from a credit grantor (usually a bank).

Various types of financing are available for short-term cash shortages, including lines of credit, demand notes, factoring/receivable financing and asset-based lending. However, keep in mind that borrowed money has its own catch-22 related to the negative impact on working capital, benchmarking ratios and such potential loan covenants as debt-to-equity ratios.

#### **Conclusion**

A construction company can be as complex and mysterious as the human body. To maintain financial health, contractors must be committed to self-examination, consultation and diagnosis with their outside financial "doctors." Isn't it time for your company's annual physical? 📍

*Anthony R. Stagliano is national director of Construction Industry Services for Mayer Hoffman McCann P.C., and CBIZ MHM, LLC in Philadelphia, Pa. Stagliano is a CFMA instructor and a frequent author for CFMA Building Profits.*

*Reprinted with permission from CFMA Building Profits Emagazine Sept./Oct. 2008*

## **Twenty point prescription for a healthy cash flow**

Lethargic cash flow slows contractor growth and development, and a cash flow embolism means death to any business. Follow this prescription to help protect your company from these risks and infuse your operations with a vigorous cash flow.

- 1.** Establish a sufficient line of credit or have another source of funds available to provide for temporary or emergency cash flow shortfalls.
- 2.** Have excess daily cash sweep first against your line of credit because the interest rate earned on short-term investment is usually lower.
- 3.** If appropriate, consider asking your bank or leasing company for a waiver or skip payments for two or three months during off-season periods.
- 4.** Have officers, owners and other related parties repay their loans as the first step towards restructuring debt and enhancing cash flow.
- 5.** Negotiate for the lowest possible retention percentage, as well as the phase-out of retention, into the payment terms of each contract.
- 6.** Require the same method of retention from your subs and suppliers to help offset your retention withheld by the owner.
- 7.** Strongly encourage the speedy resolution of proposed additions and deletions to each contract by requiring signed authorization in the field for scope changes before work begins.
- 8.** Include a contract clause providing for attorney fee reimbursement. This is critical to ensuring the collection of receivables. It discourages the owner from withholding payment and helps make litigation more cost-effective should it become necessary to file a claim.
- 9.** Assemble a knowledgeable construction industry management team consisting of your accountant, banker, surety agent and lawyer to advise your company on cash flow issues.
- 10.** Prepare and maintain a 12-month moving cash flow forecast or budget, with the first three months functioning as an early warning system.
- 11.** Always perform a "lease vs. buy" analysis prior to acquiring any major purchase, such as equipment or rolling stocks.
- 12.** Only pay bills on specially designated days of the month to enhance cash flow planning and promote office efficiency.
- 13.** Never miss purchase discount arrangements because the standard "two per cent, 10 days, net 30" approximates a 36 per cent interest rate.
- 14.** Offer your customers discounts for early payment.
- 15.** Always know your customer's approval and payment process, including the person who does the approving.
- 16.** Always deliver the first invoice in person, as well as subsequent large invoices. Also pick up cheques to help eliminate delays and excuses.
- 17.** Make bank deposits electronically to earn additional interest and to verify your customers' bank and account numbers, which allows for future verification of sufficient funds.
- 18.** Have your attorney prepare a series of standard form letters for problem customers. Many people pay upon receiving the first letter from an attorney.
- 19.** Do not fear offending or alienating your customers. Remember, persistence pays. If you can shorten your collection cycle by five to 10 days, you will have achieved a significant number of extra days of cash.
- 20.** Never lose sight of the fact that the collection of your accounts receivable is a right, not a privilege.

