CASH FLOW STRATEGIES FOR CONTRACTORS

Maintaining a positive cash flow is an integral part of success for contractors, and there are many strategies available to those who are looking to meet this essential goal.

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Cash is king. Catchy, but also true — especially for a construction or contracting company. Simply put, a contractor operating at a loss could fail. However, the same company operating with a negative cash flow will fail. The challenge to produce positive cash flow on a consistent basis is one that most, if not all, construction companies face.

Why is positive cash flow so important? For one, it ensures employees are paid for their hard work and associated payroll taxes and fringes are paid on time. Cash flow management is also crucial to ensuring the day-to-day operations are uninterrupted and can directly contribute to financing future projects.

Achieving the goal of positive cash flow appears simple: Make sure cash receipts are greater than cash disbursements. Unfortunately, small and large contractors alike may find that it is not always that simple in practice. Smaller contractors may attempt to rely on limited industry expertise when it comes to in-house accounting, which often leads to missed opportunities to maximize capital. Larger contractors with larger departments can fall short of efficient communication, which can lead to delays in billing and collection processes. The longer it takes to identify an issue, the tougher it could be to find a solution.

Strategies for contractors

Generally speaking, the ability to accurately prioritize income and expenses over time is a great start to generating positive cash flow, but how does a company actually do that? Let us outline some successful strategies.

Contracts. The precontractual stage is a vital step in setting yourself up for success, as this is when all terms are hashed out and negotiated, including those that pertain to the billing or collection process. The contract will map out exactly how and when you can expect payment and the processes involved.

It is important that you know your contract inside and out. The devil is in

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the details, as they say, and never is that more accurate than in a signed contract between a job owner and a general contractor or a general contractor and its subcontractor. Each contract should come with a contract abstract, which will explain the various key terms of the contract. This will reduce your turn-around time should any issues arise regarding billing and/or collecting.

Vendors and suppliers. It is important to frequently shop around for your materials, especially before big jobs or as you enter a busier season. Prices of raw materials fluctuate, and an established vendor will most likely meet competitor pricing to stay in your good graces. Continuously evaluating your expenses and the materials themselves will allow you to stay ahead of the curve without sacrificing quality or pricing.

Scheduling. Effective project management requires a reasonable schedule and not stretching yourself — and your timelines — too thin. In the event of unforeseen circumstances, you should be flexible enough to complete and bill a job without hindering your capacity to start a new one. This is where appropriate training for your project managers can really show its value.

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Timely and accurate billing. Invoices that are issued late get paid later. It is critical that invoices are prepared on a timely basis and comply with the contract terms. To avoid delays in receiving payment, make sure you and your client are in agreement with completed items of work and that all required attachments and addendums are provided. Once the invoice is issued, be proactive with your collection efforts and speak to your client promptly regarding overdue payments.

Collections. Stay aggressive! Your staff should always be on top of due payments and any issues that arise during the process. The more quickly an issue is discovered, the more quickly it can be resolved and you can collect what is owed to you. No contractor wants to work for free. Again, this should be obvious, but it still very true, and something as simple as staying on top of late payments can make a big difference when it comes to available cash flow necessary to take on bigger and potentially more profitable contracts.

Reduce turnaround time on change orders. Change orders can be costly. They require more time, money, and resources than originally allotted to the project. It is crucial to the overall cash flow management structure that project managers submit timely change orders and are adequately trained in change order management.

Train your key personnel on effective cash management techniques. Since roughly 85 percent of cash typically comes from work in progress, the project manager's knowledge and performance in this area are essential. In addition to proper training, it may also be beneficial to implement an incentive program based on project manager cash flow performance.

Paying bills. Always pay your subcontractors when required. The law states you must pay them out when you are paid. If discounts are an option, always aim to take advantage of those. A discount of even 2 percent will add up throughout an entire year. Keep in mind that if a bill is not due for a while, it would be in your best interest to invest that money and allow it to work for you in a way that is most suitable.

Electronic payments and automated invoices. In this day and age, every contractor should be accepting electronic payments. By doing so, money is received more quickly, which leads to more capital available for day-to-day operations and financing new projects.

Financing. When purchasing materials and/or supplies, consider financing. Of course, there is an interest charge associated with operating like this, but when payments are spread out, it opens up more cash for day-to-day operations.

Leasing certain equipment should be another consideration of any contractor. Leasing may be more cash-flow friendly if your payments are lower than what they would be if you purchased the asset outright through financing. This is an avenue worth considering if you plan to use certain equipment only for specific jobs.

A line of credit can be a useful tool as well. Depending on the amount you are approved for, this strategy can help cover situations such as mobilization and the start-up of new projects or, in a worst-case scenario, a job going unexpectedly wrong. Naturally, credit lines come with covenants, so be sure to thoroughly review the agreement.

Job management. Plan ahead on each contract and project how the job will be billed before it even starts. While over-billings can help in terms of short-term positive cash flow, too much overbilling would indicate a contractor is borrowing from Job A to pay for Job B.

Always avoid underbillings, if possible. As mentioned earlier, the ability to accept electronic payments can be a critical asset in any construction company's operations. The collections process is another essential function; it can lead to fewer bad debts and more working capital on hand.

Typically, significant underbillings represent a contractor's inefficiency in the billing process. More times than not, the existence of underbillings reflects poor billing procedures and potentially unrecognized profit fades.

Bonding. Your company's bonding potential is another key to enhancing your cash flow. It is extremely important that you plan for the surety's assessment of the company's financial statements. Some of the keys to obtaining surety credit in today's market include demonstrating that the company is well managed, completes projects according to projections, and is profitable and financially sound.

Financial statements are the focal point of the surety evaluation. Consequently, you need to have the right accountants (both internal and external) in place to offer the proper advice and provide the necessary financial information for the long-term health of your company. The financial statements will provide the overall picture of how your company is performing at any given time, and the proper internal analysis will lead to sound strategic decisions in the future. In addition to having a strong bottom line, there are a number of factors the surety will be looking into in order to assess your overall bonding potential.

- Are there any restrictions on cash?
- Are contracts billed to their completion percentages?
- Receivables from stockholders, officers, employees and affiliates should all be eliminated.
- Any change orders or claims should be resolved before being included in the total contract value, or there should be enough support on-hand to back up their inclusion in the contract price.
- Year-end purchases of long-term assets (e.g., equipment, trucks) should be purchased using long-term debt with repayment terms tied to the useful life of the asset.

Key financial ratios. Understanding the ratios found within the financial statements can help you stay on top of performance.

- Days sales outstanding: This measures the average number of days it takes a contractor to collect its receivables.
- Accounts receivable turnover: The quicker receivables turn over, the better. A surety will likely question slow-turning receivables.
- Retainage balances: High retainage balances may reflect a contractor's inability to close jobs and get the final paperwork filed.
- Working capital: This is current assets minus current liabilities, which measures funds available after meeting current financial obligations. This is a popular financial covenant that banks will add to their line of credit agreements.
- Debt-to-equity: This is determined by dividing total liabilities by owner's equity. This measures how much of the business is funded by the owners versus creditors and is another popular bank covenant.

Gross profit fades on contracts. At some point or another, every contractor will have a "bad job" or potentially even a loss job. It is just as important to work hard on a bad job as it is to work on one you hit out of the park. Minimizing damage is crucial. The more attention you give the bad job, the quicker it should go away. Having a line of credit in place

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during times like this could help alleviate the situation. More importantly, the contract should be reviewed thoroughly so that if there are any claims or change orders, they can be addressed and hopefully approved quickly.

Tax planning. Engage a good tax-planning professional and educate yourself about the tax-planning process, including the tax impact of various business activities, such as buying equipment. Also, talk to your accounting professional about depreciation methods for tax purposes that accelerate deductions and decrease tax liabilities. A smart contractor is surrounded by smart professionals, including sureties, attorneys, and bankers who understand the construction industry. Understanding these strategies and having a solid plan in place is one key to improving cash flow and to the long-term success of your business.

Infrastructure. Proper internal infrastructure is also essential in laying the groundwork for effective cash flow. From the accounting systems in place to project management tools, consistent and efficient communication between departments is crucial to ensuring everyone is on the same page and moving in the same direction.

As you can see, cash flow management is truly a mix of art and science with a lot of moving parts, but you must successfully manage the cash flow cycle from the beginning to see the true value. Profitability is important, but so is capital. Every construction company is different and should explore which of the various cash flow strategies is best for them. Long-term planning goes hand-in-hand with any business growth model, and cash flow management should be at the forefront of that strategic plan. After all, money talks. ■