

## First-Aid Kit for Contractors: A Financial Statement Review

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*Breaking apart financial reports can help expose more than just performance weaknesses; it also provides a compass to corrective actions that may need to be taken.*

New construction starts are down, developers are finding it increasingly difficult to get financing, capital budgets are contracting, commodity prices are rapidly changing and operating costs are rising. While many contractors are facing their greatest business challenges in decades, some will find success while other contractors around them do not. The successful ones remain strong in turbulent times by mining and using their financial and project information as a means to measure business health and take necessary actions.

### Cash Flow Analysis

Days cash on hand is the first metric to look at when determining financial health. The formula for calculating this is:

$(\text{Cash Resources} \div \text{Cash Requirements}) \div 365.$

The goal is to grow days cash on hand providing a “war chest” of cash that enables the contractor to more effectively react to changing market and credit conditions. Examining each component that affects this calculation helps reveal the actions a contractor may take to improve cash flow.

The primary accounts for cash on hand are cash deposits, cash receipts, investments, equity and loans. Cash receipts is the account that can be most affected by changes in business practices. The primary metric to review it is the trend of daily collections. A downward trend may be indicative of declining billings, slow-paying customers or customer satisfaction issues. How might the contractor act upon these unfavorable conditions? Here are a few ideas:

- > Placing collection calls directly to customers can immediately stimulate cash collections. Be prepared to resubmit invoices, billing backup and other invoice documentation. In addition, offering, or sometimes insisting on, personally delivering the invoice documentation and picking up the check for payment can help. Monitor the collection progress: sometimes a call from the principal to the customer is more effective than a standard collection call. If necessary, turn the receivable over to a collection agency.
- > Bill for retainage by closing out old projects and immediately billing the retainage. Retainage billing shouldn't wait for the billing cycle to occur before it is processed. Unbilled retainage is an interest-free loan to your customer and may be placing unnecessary stress on your cash flows.
- > Bill all the work in progress (WIP) for the period. There is no need for WIP to go unbilled. Payment cannot be received unless a bill is generated.
- > Leverage the overbilling process. Overbilling and front-end loading a job will shift the burden of project financing to the customer.
- > Talk with your customers! Communication is the key to understanding why they may not be paying on time. If there is a satisfaction issue or another reason why they are not paying, the contractor needs to know so corrective actions may be taken.

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- > Renegotiate contract billing terms. Ask for retainage to be released once a milestone is achieved. Shift the purchase of long lead time or capital intensive purchases to the owner.
- > Cash requirements are all of those people, bankers, suppliers and service providers that need to get paid. The time to be most concerned about this metric is when cash requirements are not matching the trends in cash resources. Here are a few actions that the contractor can implement to improve his cash requirements position:
  - > Stretch accounts payable payments. If past practice has been to pay in thirty days, moving the payment date to forty-five days will defer cash requirements by 50 percent.
  - > Renegotiate loan terms. Evaluating current loan payments to change terms or interest may reduce the current payment obligation.
  - > Renegotiate supplier payment terms. Suppliers need the contractor's business and they will work hard to keep the contractor as a customer. Ask for additional discounts, rebates, deferred payments or a structured payment schedule.
  - > Diligent tracking of project materials and supplies. The rise in commodity prices over the last few years has made excess materials and scrap more valuable than ever. Excess materials and scrap need to be returned to suppliers for credit, or sold to offset material cost obligations.

## Income Statement View

Many organizations are driven by revenue and expense reporting. Retrospectively, this information indicates project performance, estimating accuracy and back office efficiency, as well as traditional financial measures. Combined with predictive information like expense forecasts and backlog reports, the owner develops a comprehensive picture of the organization. Monitoring the income statement performance benchmarks and identifying the business behaviors that impart revenue and expense enable the business owner to implement corrective actions to positively affect the income statement.

*Revenue management.* The second set of metrics for measuring financial health is evaluating revenue. Sales pipeline, backlog and burn rate are the key indicators of revenue health. Sales pipeline shows the amount of qualified potential work. Backlog is the amount of work that has been awarded to the contractor and burn rate is the pace that backlog is being worked on. A declining sales pipeline shows that there are fewer opportunities for the contractor in the future. This is an early warning that something has changed in the market or inside the company. In either case, action is required to find new opportunities and replenish the sales pipeline. Backlog and burn rate should be evaluated together. Declining backlog with a steady or increasing burn rate often means that the project delivery engine is completing projects faster than new projects are being awarded. Market conditions will have a significant impact on revenue, and fortunately the contractor has number of options to mitigate the impact of market conditions:

- > Diligent change order management. Fifteen percent of project revenue is comprised of change orders; failure to properly track, submit and gain approval of change orders will significantly impact revenue. Indicators of change order management failure are growing unbillable project WIP, inability to overbill and project budget overruns.
- > Joint venturing with regional or national construction companies. A joint venture between a local contractor and a healthcare specialist increases the probability of winning an award that neither contractor would have previously had an opportunity to win.

- > Niche market expansion. Healthcare, senior care, higher education and sports venues continue to show strong growth. Invest in technical and market knowledge enabling entry into these markets.
- > Superior customer management. Call your customers. Show an interest in their businesses and ask about future projects. This is an excellent opportunity to verify that current projects are meeting their expectations, identify new opportunities and ask for referrals. Over half of new business comes from existing customers, and they present the best opportunities for negotiated work.
- > Customer due diligence. Great customer relationships are important to maintain, but that does not eliminate the need for thorough customer due diligence. Tight credit markets and a weakened economy necessitate running credit checks on customers and verifying project funding before starting work. Obtaining project letters of intent or letters of commitment will help verify that project funding is secure before committing construction resources and incurring project costs.
- > Selective bidding. Carefully choose the projects to bid on and minimize exposure to weak construction sectors.

*Expense management.* The third set of metrics for measuring financial health are expense management indicators. Direct labor utilization, project efficiency and overhead rate can quickly identify weaknesses in the expense structure. Direct labor equals Direct Labor Hours ÷ Total Labor Hours. Direct labor utilization should be 90 percent or more. Utilization rates below 90 percent are indicative of excessive “time on the bench” and may require reducing the labor force.

Project efficiency measures the productivity of the project delivery team. Project efficiency is calculated as Current Budget ÷ Forecast to Complete. Indices of “1” or better show that the project is on budget. Indices below “1” may be the result of aggressively low estimates, unapproved change orders or a project experiencing cost overruns. Lastly, comparing the overhead rate to industry benchmarks like PSMJ or CFMA can identify sales, general and administrative expenses that are higher than the average. Typically, overhead rates of 4 percent and below indicate a lean operation.

Here are some actions contractors can take to overcome increasing expenses and lean up their operations:

- > Rebid projects. Ask for a best and final bid from finalists before awarding contracts. A bidder who knows he is a finalist will “sharpen the pencil” and provide his most competitive bid.
- > Implement integrated project delivery. Build a vertically integrated project team comprised of general, mechanical, electrical and plumbing contractors. Develop a bidding strategy that enables the team to bid competitively, share in the profits and distribute the risk.
- > Know your supply chain. Completing credit and reference checks along with insurance and bond verification will help ensure that your supply chain will be capable of meeting their obligations during the course of construction.
- > Labor force reduction. While never easy, reduced business volume necessitates cutting costs. Downsizing the company will make a leaner and more competitive contractor.
- > Leverage automation. Automation can be the enabler to drive inefficient manual processes out of the organizations and free up full-time equivalents for other tasks. Business processes most successfully automated include: telephone reception, time sheet collection, payroll processing, accounts payable processing and project cost report production.

- > Leverage outsourcing. Specialty personnel are frequently only utilized for a small percentage of their capabilities. Consider outsourcing to a subject matter expert when needed, rather than employing the resource full time.
- > Eliminate all nonessential expenditures. Essential expenditures are only those expenses required to “keep the lights on.” Here are examples of expenses that can be eliminated or significantly reduced: travel and entertainment, club memberships, company vehicles, bonuses, season tickets, conferences and employee appreciation expenditures.
- > Control technology expenditures. Eliminate or reduce company mobile phones, issue laptops only to people who need them. Blackberry and compatible handheld computers are a luxury, not a necessity. Remember, no expense is too small to consider eliminating—it all adds up.
- > Zero budget for all expenses. Develop a justification for every expenditure and staff position. This approach challenges the “it can’t be done” attitude.
- > Evaluate insurance costs. Competitively bid insurance. Work with qualified industry experts to obtain the best quotes and verify financial stability of the insurance underwriter.
- > Reduce occupancy costs. Renegotiate leases, sublet unused space, or move to smaller and less expensive quarters. Leverage public spaces and offer work at home options to even further reduce space requirements. Reducing the occupancy footprint minimizes fixed costs.

## A Balance Sheet View

Finally, balance sheet accounts can be a source of operations, improvement, risk management, or capital to fund the company. Here are a few action items that originate from the balance sheet account analysis:

- > Cash and Cash Equivalents: Minimize the impact of financial institution failure. Implement a deposit program that is secured through high-quality investments. Overnight repurchase agreements backed by T-Bills or AAA grade bonds may mitigate deposit risk. In addition, distribute deposits at multiple financial institutions to maximize FDIC coverage.
- > Accounts Receivable: Growing aged A/R may be an indicator of customer credit issues. Initiate aggressive collection strategies to minimize A/R write-offs.
- > Fixed Assets: Significant capital is tied up in facilities and equipment. Evaluate the ROI on these assets. If the performance is below established target levels consider liquidating underperforming assets.
- > Fixed Asset Maintenance Reserve: Mandatory maintenance should be performed. Optional maintenance or major overhauls may need to be postponed until the business climate has improved.
- > Notes Receivable: Suspend the practice of issuing employee loans. In tight credit markets these are high-risk loans that consume working capital.
- > Accounts Payable: Communicate with subcontractors and suppliers. Provide assurance of financial stability and request the same from them.
- > Notes Payable and Lines of Credit: Meet with bankers. Secure sources of credit before they are needed. The banker and customer relationship is valuable during a tight credit market but the relationship is not a substitute for performing due diligence on the financial institution.



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Evaluating and implementing these action items may help a contractor successfully operate in an unpredictable economy. In addition, by adopting these business practices, a leaner more competitive contractor will emerge ready to capitalize on the future economic rebound.

#### *About the Author*

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