CONTRACTOR

November > December 2012

Are your contracts
choking your cash flow?

5 questions contractors
should ask before
buying new technology

Plus!
Construction Success Story
Local job prompts contractor
to consider joint venture

Strength in numbers

Why audited financial statements matter

Strength in numbers

Why audited financial statements matter

Sound, trustworthy financial statements are key to any construction company's success. That's why, in today's tough lending and bonding environment, every contractor should at least consider investing in *audited* financial statements.

Weighing the differences

Most contractors maintain an in-house accounting system to manage their financials. The documents your staff prepares through your in-house accounting system are called "internally prepared financial statements."

In many cases, internal financials are perfectly functional for the day-to-day operational needs of a construction company. But they often don't follow *every* reporting standard prescribed under Generally Accepted Accounting Principles (GAAP).

When an external CPA audits your financial statements, he or she will examine various accounting documents to check whether you're following GAAP and, afterward, offer an opinion on your statements. If the auditor issues an "unqualified" opinion, he or she agrees with the methods your in-house team used to prepare your financial statements.

If a "qualified" opinion is issued, it usually means the auditor has identified one or more GAAP reporting methods that your construction company hasn't followed. This doesn't mean your financial statements are inaccurate; it just signifies that you didn't prepare them according to GAAP. (There may be other reasons for a qualified opinion as well.)

Looking at both sides

Who cares whether you're in compliance with GAAP? Lenders and sureties do. Many of them require contractors to provide audited financial statements before they'll approve loans or bonding. Some local and state governments also

provide increased work and project award capacity to construction companies with audited statements.

You may even save money. Small businesses with audited statements obtained interest rates on loans that were more than half a percentage point lower than those obtained by businesses without audited statements, according to a 2011 study by the University of Chicago's Booth School of Business.

In addition, because of the extra steps an external auditor takes, audited financial statements are more likely to be free of reporting mistakes, such as data entry errors, than are internally prepared statements. For example, if your balance sheet shows that you bought a crane for $100,000, your auditor will double-check that figure by looking at your receipts.

Although audited financial statements can provide the benefits mentioned, they're not something your construction business should leap into without foresight. In addition to requiring a financial investment, an outside audit will call for you and your employees to invest a substantial amount of time and energy toward its completion. You'll need to gather and provide extensive documentation and even submit to interviews.

Don't want an audit? Try a compilation or review

Generally, contractors have three options when it comes to externally prepared financial statements: compilations, reviews and audits. Although audited statements (see main article) are the most thorough, compiled or reviewed statements may suffice for some construction companies.

A compilation is typically the fastest, least expensive option. Compiled financial statements are helpful for internal use and may support a loan or bonding application, depending on your lender or surety. During a compilation, your CPA learns how you collect financial data, formats this information and evaluates whether your financial reporting includes any obvious errors. Compiled statements don't include the accountant's opinion or any other quality assurances.

A review is a step up from a compilation. The process is usually limited to inquiries of company personnel and analytical procedures involving financial data to ensure the subject business is in compliance with Generally Accepted Accounting Principles (GAAP). Although reviewed financial statements provide some CPA assurance, the reviewer isn't required to understand the company's internal controls or test its accounting records.

If your lender or surety doesn't require audited financial statements, talk about the issue with your CPA. There may be better options. (See "Don't want an audit? Try a compilation or review" at right.)

Providing the documentation

If you decide to give a try to an external audit of your financial statements, you and pertinent staff members will meet with your auditor to establish a good working relationship and discuss timelines and responsibilities before the audit begins. From there, expect to provide documentation such as:

- The general ledger, up to date through the end of the period the audit covers,
- Original source documentation (such as canceled checks, bank statements, vendors' invoices),
- The schedule of accounts receivable,

- The schedule of priced inventories,
- The trial balance,
- The schedule of fixed assets and depreciation taken on them,
- The schedule of prepaid expenses,
- Schedules of loans, trade payables, and other liabilities reconciled with the lenders' and creditors' records,
- Schedules of all other accrued liabilities (for example, employees' accrued vacation and sick time), and
- Lease agreements, loan covenants and notes of all lenders.

Documents specific to your construction activity will also come into play. The auditor will look at financials regarding ongoing and upcoming projects and either confirm a certain percentage of the costs or test your entire job cost system. It's important to both lenders and sureties that contractors engage auditors with expertise in the construction industry.

Making the right call

Even if you're not looking for financing or having bonding troubles, think about at least an occasional external audit of your financial statements. Getting one can shed a strong, objective light on your construction company's financial health. Your CPA can explain more and help you make the right call. ■

Are your contracts choking your cash flow?

When you think about what's tying up your available dollars, a variety of culprits may come to mind. Perhaps you're servicing a substantial amount of debt, waiting for some past-due customer payments or dealing with elevated materials costs. But one perpetrator of cash flow crises that often goes overlooked is that piece of paper you sign in advance of every job.

Construction contracts — or, rather, the language therein — can start choking your cash flow before work even begins. So let's look at some points to consider before signing on the next dotted line.

Front-load, where possible

Payment terms have an enormous impact on cash flow. A contract that calls for payment on completion of specified phases of the project, for example, creates uncertainty, making cash flow forecasting difficult. A contract that requires payment in equal installments over the course of a project provides greater predictability but may not correspond to your expenditures on the job.

If possible, negotiate a front-loaded billing schedule that reflects your greater cash needs in a project's early stages.

Construction projects often involve significant upfront costs. If possible, negotiate a front-loaded billing schedule that reflects your greater cash needs in a project's early stages.

Also look at language regarding requisitions. It's not unusual for a contract to disallow requisitions for materials until the materials have been installed. To avoid cash flow disasters, try to negotiate requisition terms that allow you to request payment once materials have been delivered to the job site.

Consider the method of payment, too. You might ask for accelerated methods, such as wire transfers or electronic checks.

Review retainage

A 5% or 10% retainage can easily defer your entire gross profit on a job until after construction is completed. To reduce the impact on your cash flow, try to negotiate a lower percentage or ask for retainage to be phased out over the course of the project. For example, the contract might provide for 10% retainage, reduced to 5% when the job is 50% complete and eliminated when it's 75% complete.

Other options include limiting retainage to certain job costs, such as the labor component, or eliminating it altogether through the use of letters of credit, performance bonds or other security.

Clarify change orders

As you know, change orders are an inevitable part of most construction jobs. It's critical that your contracts establish clear terms and procedures for approving and paying them. If your contracts don't have such terms, your payments may be delayed for additional work. Or, even worse, you might lose out on those payments altogether.

Establish clear procedures for your personnel to identify changes in the scope of work and to promptly prepare and document change orders in accordance with contract terms. Moreover, before things get to the point of a change order, monitor work-in-process reports closely to ensure you can generate the proper paperwork promptly should a change come up.

Match outlays

Remember that cash does flow in two directions, and outflow is just as important as inflow. Scrutinize your contract terms with vendors, suppliers and subcontractors. You may be able to avoid cash flow problems by negotiating payment terms that, to the extent possible, match your cash outlays with your receipts from the owner or general contractor.

For example, include in your subcontracts retainage provisions that have terms similar to those in your contract with the owner. If you're a subcontractor and your contract with the general contractor contains a "pay-when-paid" or "pay-if-paid" clause, your contracts with sub-subcontractors should contain parallel provisions. That way, you won't be forced to pay subs until you collect from the general.

Get to work

Once a contract is signed and you get to work, there usually isn't much you can do about the language or terms of that agreement. So, at that point, it's critical to regularly prepare cash flow forecasts based on your work-in-progress reports and make any necessary adjustments during the course of the job. ■

5 questions contractors should ask before buying new technology

Contractors are constantly bombarded with offers of new and better technology. But it's often hard to tell whether you really need the latest and greatest tech tool or are just trying to keep up with the Joneses. Before you invest in anything, ask yourself these five questions:

1. Where could we use help? Survey your managers and employees about what they need to do their jobs better. Also question industry colleagues about their favorite upgrades. You could even engage a consultant to pinpoint bottlenecks in your current processes and locate your "technology gaps" — divides between an existing process and technology that could significantly improve it.

A system implementation that goes smoothly is the exception, not the norm.

2. What can this solution do for us? Once you determine your needs, find the right product to fill them. For example, if your company is having trouble coordinating job phases, maybe you need to update your scheduling software so you can better monitor project progress. Or if confusion often arises regarding building plans and other field documents, maybe you need an online storage tool that will allow you to centralize company data.

3. What's the total cost of ownership? Once you've settled on a product, consider *all* of its associated costs — such as the purchase price as well as the cost of installation, maintenance (including updates and patches) and repairs. Your financial advisor can help you break out every potential expense.

When you're ready to buy, exercise patience. Compare prices from three or four vendors and don't be afraid to negotiate for add-ons such as free support and discounts on future upgrades.

4. Do we have the resources (and patience) to implement this technology effectively? Typically, introducing new technology involves employee training. Can someone on staff champion the implementation process? If not, you'll likely need to budget for an outside trainer or consultant.

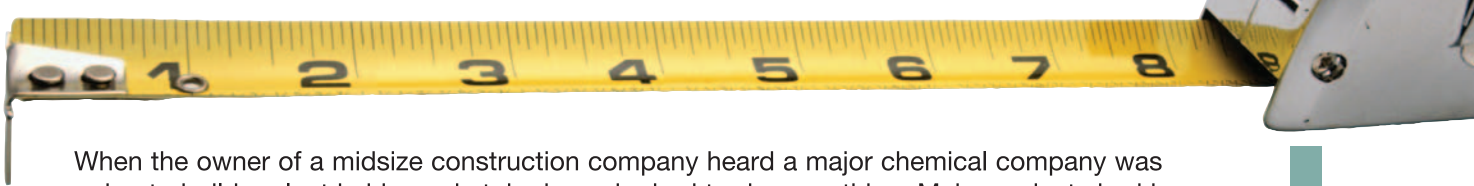
Remember, a system implementation that goes smoothly is the exception, not the norm. Also make sure the budget has a healthy cost contingency for unexpected costs and time lost.

5. Will this purchase boost our bottom line? Ultimately, weigh the technology's total costs against the potential savings or new revenues it could generate. For example, investing in a building information modeling (BIM) system will probably involve substantial upfront expenses. But it may also help you land more complex and profitable jobs.

In addition, look into tax incentives for technology investments. For instance, you may be able to deduct off-the-shelf computer software purchases under the Section 179 expensing election. Ask your tax advisor whether you qualify or if other federal or state tax incentives are available. ■

Construction Success Story

Local job prompts contractor to consider joint venture



When the owner of a midsize construction company heard a major chemical company was going to build a plant in his market, he knew he had to do something. Major projects had been hard to come by recently, and this one could be a big boon to his bottom line. Problem was, his company lacked the labor and some of the equipment to field the project alone.

For the first time in his career, the contractor began to consider proposing a joint venture with another area construction business. Before approaching prospective partners, however, he met with his financial advisor to discuss the idea.

Advantages, risks

Joint ventures do offer advantages, the advisor confirmed. They allow smaller construction businesses to take on larger projects while dividing the contractual and financial risk of such jobs between two parties. A joint venture can also enable contractors to increase their bonding capacity and learn about the newer, more sophisticated technologies that typically accompany bigger projects.

Despite the potential positives, the advisor warned, partnering with another business can present risks. Partners who fail to clearly define the objectives and responsibilities going in can wind up legal adversaries. Communication problems may result in delays and redundancies that undermine profitability.

Money, taxes

The advisor told the contractor that companies generally form joint ventures for one specific purpose, such as the chemical plant project, for a limited time. Partners negotiate beforehand how they'll split profits and expenses based on the time, money and labor each plans to invest.

For tax purposes and personal liability protection, many joint ventures form a separate business entity — often a limited partnership or limited liability company (LLC). If the contractor went this route, his advisor said, they'd need to look carefully at the tax implications.

Finances, ethics

When considering a prospective joint venture partner, the advisor recommended looking at the company's finances, including an extensive review of its financial statements. They'd also need to check into the prospect's legal standing, such as whether the company is involved in any outstanding lawsuits or unsatisfied judgments. Last, there's the issue of ethics. The contractor and his advisor would need to check references and do some research to ensure a prospective partner doesn't have any history of questionable practices.

Challenges, victory

Armed with his advisor's input, the contractor eventually found a solid partner, and the two companies won the chemical plant job. The job was hardly easy but, after working through the challenges, the two contractors declared the joint venture a solid victory. ■