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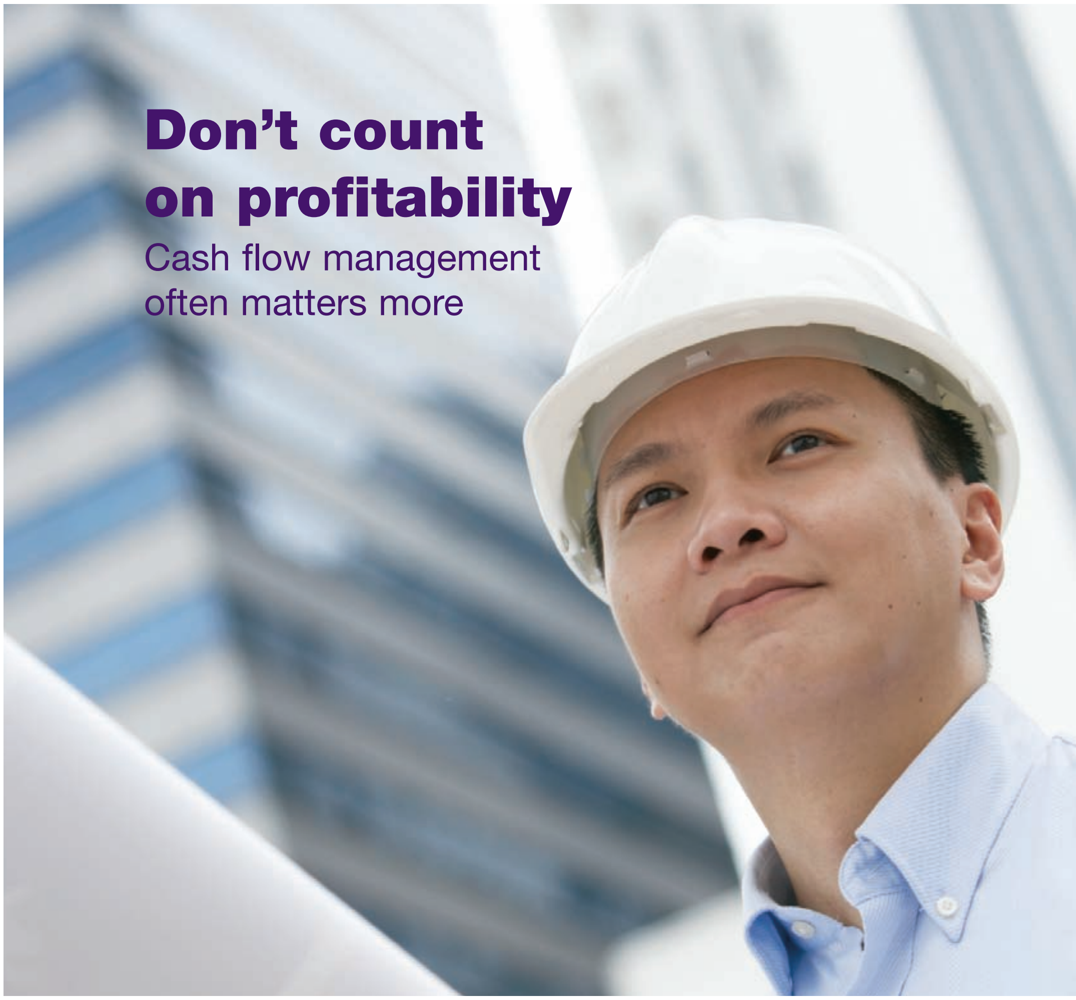

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Don’t count on profitability

Cash flow management often matters more

Every business has its slow periods, but construction companies are particularly susceptible to ebbs and flows in income. For this reason, cash truly is king for contractors.

In fact, more construction companies go out of business because they run out of cash than because they don’t show a profit, according to the Construction Financial Management Association. What this means is that cash flow management often matters more than profitability.

A cash flow projection

When money is tight, your first instinct may be to go after more work. That’s logical, but it may not be the best approach if doing so only ties up more cash.

Before you submit another bid, put together a realistic cash flow projection to help you decide whether you can afford another project. Such a projection can also enable you to pinpoint precisely what type of job would be within the grasp of your current cash flow.

To develop a projection, look at the jobs you have scheduled for the next year. Keeping in mind that things could change, lay out your expected cash flow needs, by month if you can, for each job. Don’t overlook your expected nonjob outlays, such as overhead, materials, labor, subcontracts and permits.

Also bear in mind that what makes up job costs on any given project can significantly affect the working capital needed for that job. For instance, labor and equipment costs generally need to be paid currently before a contractor is paid for his or her work. Meanwhile, materials and subcontractor costs often don’t need to be paid until the construction company collects from the general contractor or owner.

Make cash flow management a routine endeavor rather than a once or twice a year activity.

Then look at your expected revenue by month. Timing may be difficult to predict if you’re doing a job for a new owner or are planning a project on spec, but you can use your historical payment data to calculate an average for planning purposes. This same data, accumulated over time, also can give you an idea of how quickly certain owners typically pay their bills.

When you’re finished, you should have a good idea of when you might run short of cash in the next 12 months — and you can plan accordingly.

Other recommended strategies

Of course, a sound projection alone probably won’t be enough to keep cash flow problems at bay. Other recommended strategies include:

Financing long-term purchases. Generally, you should avoid debt. But, when trying to procure long-term assets such as heavy equipment, it’s often unavoidable. In these cases, try to match those long-term assets with long-term debt. In other words, if you’re going to own something for an extended period, pay for it during that time frame and save your cash for other purposes.

This is, again, where projecting your cash flow can save you from future headaches. Whenever possible, set aside money for anticipated capital needs and reserve financing for unanticipated needs.

Improving your change order management. Change orders and claims cost you money. If you're having trouble in this area, devise a better system for getting them approved and paid more quickly. Easier said than done, of course, but try to get a feel during contract negotiations as to how change orders will be handled. Also look into increasing your margins on change orders to compensate for your cash outlays.

Tightening up your billing. It goes without saying that you don't want to underbill. But be strategic with your overbilling: Doing so requires discipline and strong cash management skills. You need to allocate dollars properly, and you aren't likely to accomplish this by looking only at your bank account balance.

Getting paid faster. Make sure your billing and collection procedures are fast and efficient, and that you have follow-ups in place to deal with any slow payors. You may need to be more aggressive in collecting your receivables.

Watching your inventory. You need a certain amount of materials on hand to keep your jobs rolling smoothly, but you may not need to keep quite so many on hand. Plan your orders so you can keep your inventory as close to zero as possible without jeopardizing project timeliness.

Resisting temptation. This is a strategy just about anyone can apply to his or her personal life as well as a business. Before you invest in something that will affect your cash flow, ask yourself whether it's really necessary. If it's just something that would be nice to have, look at your cash position and really think about whether you can actually afford it.

"Thinking cash" — always. Whether you're negotiating contracts, budgeting for a project, buying office supplies or doing any other business activity, think of it as a chance to improve your cash flow. Make cash flow management a routine endeavor rather than a once or twice a year activity.

The lifeblood of your business

Cash flow is the lifeblood of any construction business. So if yours is going strong, give yourself some credit. But don't take it for granted — one job-site disaster or even just a series of unexpected misfortunes can put a choke hold on even the strongest of cash flows. ■

2 ways to boost cash flow with savvy banking

As you work to manage your cash to your best advantage, don't overlook your bank. Today's lending institutions offer a number of arrangements that can improve your cash position. Two in particular are:

1. Zero-balance arrangements (ZBAs). You can use a ZBA to minimize the money you keep in a non-interest-bearing account. ZBAs automatically transfer money in and out of your primary account to cover your daily activity and still maintain a zero balance. You can link several accounts to your primary operating account for automatic funding.

2. Sweeps against line of credit. You can use a similar process — a sweep against line of credit — to reduce the interest you pay on your line of credit. A one-way sweep transfers money from your line of credit to your checking account when the balance drops to a certain amount.

Two-way sweeps also transfer money out of your checking account when the balance is more than a specified amount. The money is used to pay down outstanding principal.

Get a handle on your supply chain with materials management software

A supplier bills you for materials, but you don't have them and nobody knows whether they were ever actually delivered. The crew couldn't keep the job on schedule without the supplies, so somebody went out and bought what was needed, and now you have to spend valuable time investigating what happened to the lost shipment.

This is a sad tale, and one heard all too often on construction sites everywhere. Fortunately, today's materials management software can help you get a handle on your supply chain — and save money in the process.

It's all about timing

There's no question that it's a challenge to keep material flowing to busy job sites. And much of this challenge springs from difficulties involving timing.

If you order too far in advance, you're tying up capital that you could use for other purposes — as well as running the risk that materials will be lost, damaged or stolen before they can be used. If you wait too long to order, you risk job delays and rush expenses to get what you need as fast as possible.

The easiest way to avoid such woes is to give your project managers a report of what materials will be delivered, along with copies of the relevant purchase orders, and then instruct them to check what's received against what was ordered. But doing so means someone has to prepare the report every week or month, which could be a gargantuan undertaking with plenty of opportunities for mistakes.

There's a better way

A better alternative may be to automate your supply chain with materials management software. These applications allow you to, among other things, track what you've ordered and notify you of what's been shipped — and what hasn't.

In addition, materials management software enables you to put together tentative materials delivery schedules at the beginning of each job as well as more up-to-date short-term schedules during the project.

What's more, if the software is Web-based, everyone in your supply chain — including the suppliers themselves — can access it to know at a glance how the project is proceeding and when materials will be needed without investing in additional hardware or software.

Moreover, as the system creates reports telling you when deliveries were ordered, when they were promised, when they were shipped and when you received them, you can determine each supplier's on-time delivery rate as well as the lead time for orders and deliveries.

Due diligence is a must

Naturally, materials management software is hardly without risk. Rush into the purchase and you might overspend on a solution that, ultimately, provides an unsatisfying return on your investment. Even if you find the right package, you still may encounter a lengthy learning curve, during which you could actually compromise your ability to track your supply chain.

So, before you buy anything, do some due diligence: Research prospective products — and their vendors — thoroughly. Look for a solution that suits not only the number of jobs your construction company typically undertakes, but also the technical savvy of the people who will use the software. ■

5 ways to strengthen your surety relationship

Call it a "necessary evil" or "the cost of doing business." However you want to look at it, for most contractors, bonding is a fact of life. One way to keep your bonding capacity strong is to maintain a strong relationship with your surety. Here are five ways to do just that:

1. Communicate regularly and effectively. For starters, keep the lines of communication with your surety wide open at all times. Consider your surety agent part of your overall advisory team, just as you do your accountant and attorney.

To make sure your agent is always aware of what your company's doing, send him or her regular financial reports as well as updates on your current project load. And even if nothing particularly earthshaking is going on, give him or her a call occasionally just to say hello. Sometimes a little goodwill can go a long way.

> Sureties look for evidence that you've managed to stay profitable over the long term.

2. Keep your financials in order. Assuming you are sending your surety regular financial updates (and you should be), you need to make sure you're providing the right information. Sureties tend to focus on equity and working capital. If you can demonstrate that you're managing your cash flow, and that you have enough working capital to see you through any unforeseen problems, you'll generally stay on a surety's good side.

Sureties also look for evidence that you've managed to stay profitable over the long term. By nature, the construction business has highs and lows. So if you can consistently demonstrate a steady history of profitability, you'll show your surety that you clearly know how to get through the lean times.

3. Carefully organize contract information. To ensure a construction company isn't taking on an unacceptable amount of risk, a surety will sometimes want to review recently completed

contracts as well as those in progress. Thus, you need to keep your contract documents complete and well organized in case your surety asks for them.

It also helps to augment your contract documents with background on your customers. For instance, if you're seeking a surety bond for a private construction project, rather than a public one, the surety may want to know how the owner plans to pay for it. You may need to provide the source and amount of funding involved.

4. Maintain a sound business plan. A sound business plan that clearly indicates not only where you're going, but how and why, can put (and keep) your surety at ease. When a construction company has a written, up-to-date plan, sureties think it's less likely to go off on a risky tangent.

Similarly, a contingency plan that shows how you'll deal with financial emergencies demonstrates your ability to remain cool under fire. Creating a disaster recovery plan that delineates your planned response for natural and manmade catastrophes is also a good move.

5. Document your company's credentials. Your ownership and management profile may be another feather in your cap. A team of experienced managers and owners who have significant equity in the company is a sign of commitment that sureties appreciate.

In other words, don't be afraid to blow your own horn. Write detailed bios on yourself and your top managers. And if you have a formal employee incentive program, provide your surety with detailed records of it to show off the accomplishments of your staff and work crews. ■

Psst — wanna buy my construction company?

ESOPs offer another retirement option

As many contractors near retirement, they begin to wonder what to do with their businesses. In many cases, the answer is to sell to a third party, transfer ownership to family or key employees, or liquidate. There is, however, another option worth considering — the employee stock ownership plan (ESOP).

What's the deal?

An ESOP is an employer-sponsored, qualified retirement benefit plan that allows a company's ownership to sell some or all of the business to its employees — without bringing in outside buyers.

Despite the name, however, you don't sell shares in your construction company directly to employees. Rather, a trust buys as much of the business as you want to sell. Employees make no direct contributions; instead, the trust pays into their individual ESOP accounts.

Why do it?

In part because sureties take a dim view of anything that ties up cash over the long term, contractors haven't used ESOPs as frequently as business owners in other industries. Properly structured, however, an ESOP may actually enhance a construction company's bonding capacity.

With labor shortages being all too common in the construction industry, your surety may view an ESOP as an effective means of retaining employees and, thus, promoting operational stability. Why? Because ESOP accounts grow in value over time, employees may think twice about leaving your company.

ESOPs can provide significant tax advantages, too. In a "leveraged" ESOP, the trust borrows money from a bank to buy up to 100% of the stock in your company. You can claim a tax deduction for all contributions used to pay interest on the loan, and you may deduct amounts used to make payments on the loan principal up to 25% of the covered payroll expense.

In a "nonleveraged" ESOP, you contribute up to 25% of eligible payroll funds to the plan, which then uses these tax-deductible contributions to buy company stock, either from existing shareholders or directly from your construction business. This is a simpler option, but it doesn't provide substantial amounts of immediate cash to shareholders or your company.

Last, because the value of each ESOP account is directly related to the company's overall profitability, the arrangement may improve productivity. The key here is making sure employees fully understand how the ESOP works.

What about risks?

Of course, there are risks to an ESOP. If your company borrows money and then lends it to the ESOP to buy stock, you must record the bank loan as a liability and debit the same amount to the equity account. That effectively reduces your net worth by the amount of the debt.

And if the stock value soars, the ESOP may not have enough cash to buy it back when someone retires. This means a portion of the trust fund should be in liquid investments.

Last, banks typically get first priority on assets if the unthinkable happens and you have to liquidate. Sureties may be uneasy about this as well.

Are there other, similar options?

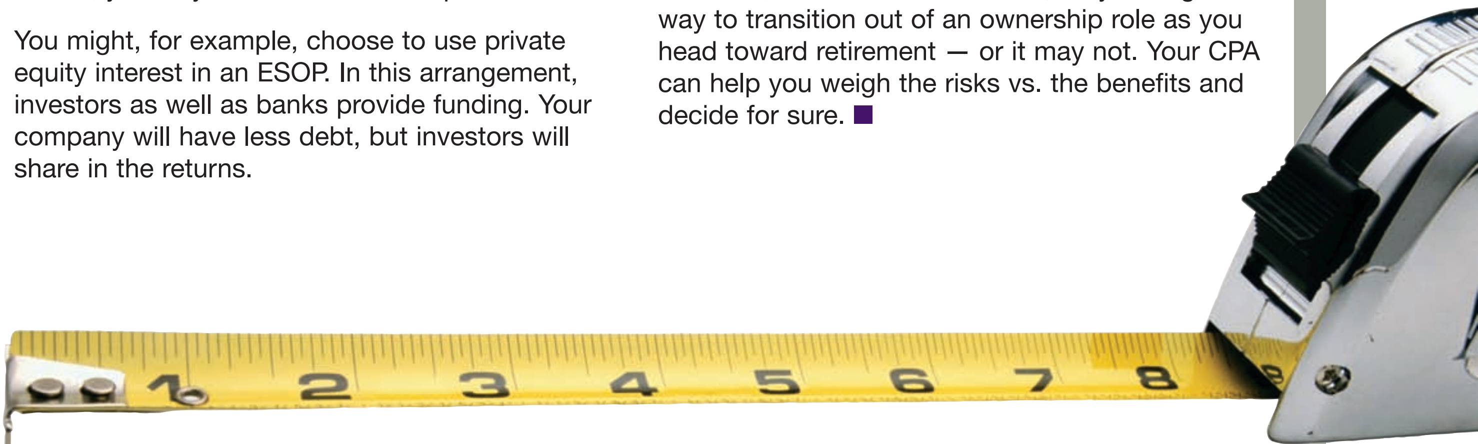
ESOPs tend to be most beneficial for mature construction companies with large nonunion workforces, growing but stable earnings and consistent revenue sources. If your business doesn't fit those criteria, you may have other, similar options.

You might, for example, choose to use private equity interest in an ESOP. In this arrangement, investors as well as banks provide funding. Your company will have less debt, but investors will share in the returns.

You might also combine an ESOP with a management incentive plan or a select manager buy-in, which would allow key personnel to buy stock out-of-pocket. Or you could create a performance-based award that allows selected managers to earn equity if business appreciation hits a target goal for the year.

Who can help?

An ESOP, in one form or another, may be a good way to transition out of an ownership role as you head toward retirement — or it may not. Your CPA can help you weigh the risks vs. the benefits and decide for sure. ■



Construction Success Story

Contractor creates a total communications plan

The owner of a midsize construction company that specializes in commercial projects was growing increasingly concerned that many of her staff members felt left out of the communications loop. And she wanted to restore morale without blowing her budget on expensive technology. For guidance, she turned to her financial advisor and, together, they devised a cost-effective "total communications plan."

For starters, because everyone on her management team already had a cell phone, she and her advisor agreed that she should establish weekly phone calls with each job-site manager. Doing so would give the managers a routine, reliable opportunity to report progress and discuss any new challenges or issues.

The calls would also allow the contractor to pass along tidbits, such as birthdays and employment anniversaries, to keep off-site employees feeling part of the team. In addition, she would announce that her phone would be on 24/7. So remote employees would be able to report problems and garner her advice at any time.

Next, the contractor and her advisor looked at the company's e-mail capabilities. Although remote employees could access their e-mail through a Web page, they couldn't always view or send attachments. To solve the problem without overhauling the entire system, the contractor decided to set up a File Transfer Protocol (FTP) site on its server. It would allow employees to upload and download files from any location, including very large files (such as those exceeding 100 MB).

At the same time, the two recognized that nothing can replace face time for building employee loyalty. The advisor found a way to add some dollars to the contractor's travel budget so she could visit each job site regularly. She would spend the day observing work, discussing concerns and generally just strengthening connections with her crews.

After assessing the cost of her total communications plan and refining it a bit, the contractor put it into action. So far, the results have been good. She's not only more aware of the day-to-day progress of all of her company's projects, but also more familiar with the names on her payroll.

The expertise you need, the service you want.

At Smith & Gesteland, LLP we know that running a successful construction company these days requires more than just dedication and hard work. It takes the assistance of experts who understand the industry and the challenges contractors face, and who have the specialized knowledge, hands-on experience and service commitment it takes to help them achieve their business goals.

Our Construction Industry Services Group consists of experienced professionals focused on increasing the success of companies like yours. For more than 50 years, our firm has served individuals and businesses throughout south central Wisconsin. We are delighted to currently work with more than 100 contractors and to have recently been voted Madison's Number 1 accounting firm. We are ready to assist you with a broad range of services tailored specifically to your needs, including:

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- Bonding capacity maximization
- Lease vs. purchase analyses
- Tax reduction strategies
- Business valuations
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- Financing assistance / growth management
- Project management and accounting systems
- Litigation and claims support

As specialists in the construction industry, Smith & Gesteland has developed the expertise needed to help contractors address and meet their many challenges. We would welcome the opportunity to help you build your success.

To find out what we can do for you, or for more information about the ideas presented in this newsletter, please contact John Folsom or Steve Pullara at (608) 836-7500 or mail@sgcpa.com. We look forward to talking with you.

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