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Have a question?

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Points to Ponder

“Each of us is carving a stone, erecting a column, or cutting a piece of stained glass in the construction of something much bigger than ourselves.”

Adrienne Clarkson
Canadian Stateswoman



PROFIT CLUE™

Profitability Tips for Construction Businesses

Summer 2008

Cash Flow: Long Live the King!

Cash is King.

Every profit-minded business should take this saying to heart.

But the capital-intensive nature of most construction businesses makes it that much more important to manage cash flow effectively. Failure to do so can undermine a seemingly healthy business or worsen problems during lean times. By taking some well-planned steps, you can ensure that enough cash will be available when you need it.

1. Cash flow management starts with knowing the customer. Before accepting any work, find out if any liens have been placed on past jobs or if the owner or general contractor has a history of litigation. Local chapters of the Better Business Bureau and trade associations can provide such information.
2. Billing and payment terms are another essential factor in cash flow management. Establish payment parameters in the contract, and consider negotiating for accelerated billing terms. Keep in mind that if work was completed early in the month, end-of-month billing can result in a billing cycle that is closer to 60 days than 30 days.
3. Cash flow projections can reveal looming shortages that would otherwise catch you by surprise. Estimate when costs will be incurred and paid and when progress billings will be collected on current and expected contracts. Compile these project cash flow projections, along with anticipated indirect costs, into a company-wide cash flow projection.



This timeline of cash flowing into and out of the company gives you an indication of when you'll need to draw on a line of credit and when you can start paying on overhead items.

4. Accurate job-cost allocation ensures all expenses are accounted for and recouped. While labor and overhead costs are usually factored in when determining the contract price, they are often neglected during the accounting phase. Be sure to allocate these costs properly. Otherwise, you may be understating your costs, which can lead in turn to understated progress billings.

Remember: Profitability is ideal, but your company will ultimately be measured on how much cash it has at the end of the day. ■

Cash Demand Period

Key financial performance indicators (KFIs) help provide company focus, align organizational action and serve as financial benchmarks to guide performance. Periodically, ProfitClue will focus on one of the KFIs that construction companies should monitor. By monitoring Cash Demand Period (CDP), contractors can anticipate and take steps to prevent cash flow problems. CDP is essentially the difference between the length of time it takes to receive payment for inventory and work-in-place and the length of time you have to pay creditors.

To learn more about key financial indicators for construction companies, or to request a copy of our *Key Financial Performance Indicators Best Practices Guide*, call Vito Loisi at 630-545-4554.

attention to the following critical factors:

- 1. Minimize underbilling.** If a project is persistently or significantly underbilled, there may be quality or performance issues at fault. Dig deeper to reveal and respond to such problems quickly and ensure those receivables turn into cash.
- 2. Maximize overbilling.** Negotiate progress payments based on a schedule of values, and discourage payment based on invoice, which requires excessive accounting support and can result in project costs missing the billing cycle.

The formula to calculate this KFI is:

$(Days\ in\ Accounts\ Receivable + Average\ Days'\ Underbillings) - (Days\ in\ Accounts\ Payable + Average\ Days'\ Overbillings)$

To reduce the cash demand period and minimize the amount of cash needed to fund operations, pay

- 3. Reduce the amount of time it takes to collect receivables.** A formal and rigorously followed collection policy is your best bet here. Hold project management accountable for receipt of payment and get senior management involved with aged receivables.

- 4. Use – but don't overuse – credit.** Bad things happen even to good companies. Prepare for that possibility by establishing a line of credit well before it's needed.

Who's Who in ProfitCrew™

Who: John Winquist, CPA, MAS is a manager and member of Wolf & Company LLP's *Construction and Real Estate Industry Group*.

John works with clients in many industries including construction, manufacturing, distribution and services. He provides traditional accounting, audit and financial consulting services to his clients.

What he does best: John devotes a substantial amount of time working with clients in the construction industry. He helps them improve the strength of internal controls in their accounting processes and identify areas for business improvement.

John is a member of the American Institute of Certified Public Accountants, Illinois CPA Society, and the Home Builder's Association of Greater Chicago.

In his spare time: John lives in the Lincoln Park neighborhood of Chicago and enjoys supporting new restaurants in the area. He devotes time to a not-for-profit organization that raises money to support a local children's hospital. He enjoys learning the game of golf and is an avid follower of the Chicago Bears, Bulls and White Sox.



Questions

Answers

Question

What are some practical steps I can take to improve cash management?

Answer

Consider the following cash-flow boosters:

1. Negotiate for early release of retainage billings, or total exclusion from retainage. Expedite

the punch list closeout phase to free up retainage billings more quickly.

2. Take advantage of purchase discounts by paying early. And if payment terms don't allow for discounts, pay on time, but not before. On the flip side, consider offering early payment discounts as an incentive to your customers.
3. Use all cash equivalents before borrowing for working capital

needs, and do not use short term financing to pay for purchases of long-term assets, such as heavy equipment.

4. Perform year-end tax planning before the end of your fiscal year to take full advantage of all income tax deductions and deferrals.

Compare actual job costs to estimated job costs regularly in order to highlight any problems before it is too late.