Abbott, Stringham & Lynch
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Dimensions

A CPA's Report for the Construction Industry Fall 2023

Vetting Subcontractors

Why Subcontractor Reviews Are Especially Important Now

During the summer of 2020, the federal government implemented the Paycheck Protection Program (PPP) to help businesses keep their doors open in the face of government-mandated shutdowns due to the COVID-19 pandemic. Businesses across many industries took advantage of this program, including many construction firms and subcontractors.

These funds allowed subcontractors to grow and expand, especially during the pandemic construction boom that was experienced across much of the country. Some of them ventured into trades and geographic areas where they had limited experience, hiring new employees, and buying new kinds of equipment and materials.

Meanwhile, some subcontractors took PPP funds out of the company as distributions while others segregated the money in a separate bank account, saving it for a future "rainy day."

Declining Balance Sheet Quality Among Subs

Three years later, some general contractors are starting to observe a decline in balance sheet health as subcontractors continue to face headwinds due to labor shortages, material price volatility, and an uncertain economic outlook. As a result, many have fully depleted their PPP and Employee Retention Credit (ERC) funds.

Some subcontractors who received PPP funds had a sense of security knowing they had cash in the bank. In certain instances, this led to a declining level of scrutiny in individual project profitability. Organizations with this false sense of security may have perpetuated bad habits, such as not performing project profitability analysis or applying sufficient diligence to job costing.

Some of this is coming to light now in the form of declining profitability on subcontractors' jobs. However, they no longer have PPP funds sitting in the bank to help compensate.

Less-sophisticated subcontractors aren't aware of the rapid material, labor, and indirect cost escalations over the past few years and haven't done a good job in cost accounting these elements to uncover their true project profitability. So be especially wary of low bids and the assumptions they're based on to guard against subcontractor failure in the middle of a project.

Unfortunately, the construction industry is a known laggard in the adoption of evolving technology advancements. Many subcontractors tend to use archaic financial reporting systems that don't provide the transparency or data needed for accurate job costing and transparent financial performance.

New capabilities are being designed into modern contractor accounting systems that allow for seamless and automated information

Cash Management for Contractors

Eight Ways to Improve Your Cash Flow

Cash management is critical for contractors, but especially in the current economic environment. High inflation, rising interest rates, and several high-profile bank failures have made it more important than ever that contractors and construction firms manage cash efficiently.

Consider these eight contractor cash management tips for an uncertain economy:

1. Ensure efficient collections. Strong cash management starts with collecting receivables as quickly and efficiently as possible. Make it easy for customers to pay by offering as many payment options as possible, including electronic, and send out invoices on a timely basis.

2. Track job progress carefully. Make sure you have a good accounting system in place to track progress on percentage of contracts completed so invoices are sent at the appropriate job benchmarks.

Also manage over-under billings on completion of contract jobs carefully. If invoices are sent too late, costs might exceed billings, which could lead to an accounting imbalance and eventually a cash flow crunch. Don't divert this cash for any other use or it won't be there when you need to cover job costs.

3. Take advantage of payment terms when offered. If a supplier offers 30-day payment terms, there's no reason to pay in anything less than 30 days. This is essentially free supplier financing so take full advantage of it.

4. Offer prompt-pay discounts to customers. On the flip side, it might make sense to offer customers a small discount for paying their invoices early, which will help boost your cash flow. With a 2/10, net-30 discount, for example, customers would receive a 2 percent discount for paying invoices in 10 days instead of 30 days.

5. Budget for retainages. If a customer is holding back 5 or 10 percent for retainage, be sure to factor this into your cash flow projections and anticipate a potential cash flow shortfall. Establish a line of credit with your bank to carry you over should this occur.

6. Stay on top of change orders. These can accumulate over the course of a job and add up to a tidy sum. Make sure you have a system in place to track change orders and get paid for them.

7. Finance capital expenditures. Some contractors use cash on hand to pay for equipment and other big-ticket items. Capital expenditures like these should be financed instead, either with a bank loan or equipment lease. Leasing is more advantageous from a cash flow standpoint; perform a lease-buy analysis to see which option is best for you.

8. Build price-adjustment clauses into your contracts. While inflation has subsided in recent months, material prices are still rising in many areas of the country. Consider adding clauses to your contracts that automatically increase prices to account for inflation. Also consider purchasing and stockpiling certain materials at today's prices if you know you will use them in the future.

Talk to your financial management team about how these tips could help boost cash flow at your construction firm.

Contact our firm to talk more about strategies to improve cash management at your business.

Cash Reserve Management Strategies

In light of big bank failures like Silicon Valley Bank and Signature Bank earlier this year, construction firms are exploring different approaches to risk mitigation. Their emphasis is on handling cash reserves while balancing high interest rates versus liquidity concerns.

For example, some construction CFOs are diversifying cash reserves into investment accounts, utilizing insured cash sweeps, and exploring supplemental banking institutions. Insured cash sweep (ICS) accounts allow firms to shuffle liquidity around without having to open new accounts.

Meanwhile, rising interest rates and laddering U.S. Treasuries have some construction firms considering different approaches to balancing higher rates against liquidity needs. Some ICS accounts offer more liquidity than CDs that require longer time commitments in exchange for higher rates.

Vetting Subcontractors

Why Subcontractor Reviews... *Continued from page 1*

flow through application programming interfaces (API). This helps eliminate data confusion and manual data analysis, leading to faster and more accurate information to drive decisions for increased profitability.

Review Subcontractors' Financial Information

Given these trends and the uncertain state of the economy, some general contractors are being more proactive in analyzing subcontractors' financials before accepting bids. This includes reviewing subcontractors' financial statements based on current assets and liabilities and the size of their backlog to evaluate whether they have the bandwidth to take on another project.

When reviewing subcontractors' financial statements, try to determine how easily they can meet the financial demands placed on them during a job. Among other things, you should satisfy yourself that you're considering working with have:

- Strong cash flow and working capital.
- A healthy current ratio.
- Accounts receivable in line with gross income.
- A balanced over/under billing position.
- Consistent profitability from one job to the next.
- A manageable project pipeline that isn't going to overextend their human resources and technical capabilities.

Audited or reviewed financial statements prepared in accordance with generally accepted accounting principles (GAAP) are preferred for evaluating subcontractors. Ideally, statements will be prepared by a CPA with experience in the construction industry. The following are potential red flags that a financial statement review might uncover:

- Inappropriate or inconsistent revenue recognition practices.
- Under-allocation of indirect job costs to individual projects.
- Overstatement of the entity's receivables or contract assets.
- Understatement of potential litigation and claims on the entity by third parties.
- Too much equity committed to a single project.
- Excessive dividends and distributions taken by owners.
- Significant early billings on a project that aren't accounted for as cash or receivables on the balance sheet, which could indicate that the money is being used to cover costs on another job.

Other Info to Request from Subs

In addition to financials, it's also smart to ask potential subcontractors for other information and documentation, including:

- Resumes of management team members and succession plans.
- References and letters of recommendation from clients of recently completed jobs.
- Area of geographic reach.
- Work history, including jobs completed and in progress.
- A list of current and upcoming projects (to demonstrate capacity).
- Safety management programs and historical safety records, including OSHA Forms 300 and 300A.
- Certificates of insurance and surety bonding capacity.
- Any material litigation, claims, bankruptcy, or disputes over previous work.

Based on your review, you could develop a rating system for potential subcontractors. Whether it's a point scale or simply pass/fail, such a system can provide objective criteria and help speed up decision making during the subcontractor bidding process.

You can streamline the subcontractor review process by creating an online portal to which they can submit their information. This way, subcontractors only have to enter their information once, with periodic updates as required. The information will be automatically routed to all the decision makers at your company, who can assign their own ratings independently.

Dealing with Pushback from Subs

Some subcontractors might push back to GC requests for financial statements and work in progress reports since they contain sensitive financial information, including gross profit margins on jobs. Many subcontractors also hesitate to share information about owner distributions and company payroll.

In these instances, subcontractors may be able to provide limited financial statements that include a balance sheet and equity statement but exclude the income and cash flow statements and all references to footnotes. This will demonstrate their financial viability without revealing sensitive information like gross margins that many subcontractors would rather keep private.

Regardless of what level of financial information subcontractors provide, assure them that any information or documents they share with you will be confidentially reviewed by a limited number of people at your company and then destroyed.

Uncover Potential Problems Sooner, Not Later

The time to uncover financial concerns about subcontractors is before, not after, hiring them as your partner. Following these steps can help reveal potential subcontractor problems before it's too late.

We can help you vet potential subcontractors. Give us a call to discuss your situation further.

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How to Win the War for Talent

Labor shortages continue to plague the construction industry. Construction firms will need to hire an additional 546,000 workers on top of the normal pace this year and an additional 342,000 workers next year, according to Associated Builders and Contractors.

One reason for the shortage is the aging construction labor force. The median age for a construction worker is now 43, and one out of four construction workers is older than 55. This makes it imperative that contractors strive to make construction employment appealing to younger generations, including Millennials and Generation Z.

Many of these younger workers value career advancement opportunities and the potential for personal growth in their jobs, along with work-life balance. Consider offering cross-training opportunities and leadership development courses for those who are interested in the management track.

Be prepared to invest in the training needed for these employees to advance their careers. Adopting new technology tools like project management and estimating software, document management systems, and drones and robotics will show them you're committed to their long-term success with your company.

Also get creative with employee benefits. In today's environment, health insurance and retirement benefits are just stable stakes. Consider offering generous paid time off and other perks like "free food Fridays," education allowances, and gift cards for employees who go above and beyond.

The pandemic gave some employees a taste of working from home and many don't want to give this up. Therefore, allow your office and administrative employees to work remotely at least one or two days a week if they can perform their job duties from home.

Now is the time to plan strategically for how to meet the staffing challenges facing the construction industry. Failure to do so could limit future growth opportunities for your firm.