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Financial management for contractors

BUILDING AND MAINTAINING A CAPITAL RESERVE ACCOUNT

Capital reserve accounts can provide more than just a safety net for businesses — they can serve as a cornerstone for enduring financial stability. This is particularly true in construction, which consistently ranks highly on lists of industries with the greatest business failure rates. Let's explore some best practices for building and maintaining a capital reserve account.

The case for capital

The term "capital reserves" generally refers to liquid capital set aside for broadly defined emergencies. In this context, emergencies can range from the unexpected need to replace an essential piece of equipment to covering fixed expenses during an economic downturn or other disruption.

As mentioned, capital reserves are especially critical for construction companies, which typically operate on a project-based revenue model that often leads to fluctuating cash flows. As you've likely experienced, unexpected project delays or the need for additional materials can easily blow even the most carefully crafted budget.

What's more, one need look no further than the recent pandemic to see the vital role capital reserves can play in sustaining operations when the unexpected hits. Many contractors faced job delays or shutdowns while they still had bills to pay. Meanwhile, construction businesses with sufficient reserves were able to focus on matters such as contingency planning or finding additional revenue streams, rather than scrambling to cover expenses.

Capital reserves also reduce the need to take on additional debt to meet project deadlines. Lender financing not only comes with interest, but also can hamper your borrowing capacity down the road.

Building blocks

If you don't yet have a capital reserve account, you might understandably wonder where you're going to find the extra cash to get started. Commonly used approaches include:

Reducing overhead. Review your overhead expenses to look for possible reductions. For example, the pandemic abruptly showed many types of companies that they may not need to maintain large suites of offices to operate successfully. You may be able to lower lease and utility expenses through remote or hybrid work arrangements. You also might find you're paying rental fees for unused or sporadically used equipment.

Shedding inventory. Some construction businesses maintain inventories to reduce supply chain risks. If your company does, keep a close eye on it. Although useful under the right circumstances, inventory represents inaccessible cash and can generate high carrying costs. Consider selling off long unused inventory and trimming your regular order amounts.

Re-evaluating lending arrangements. With interest rates finally stabilizing, now could be a good time to review

SO, HOW MUCH DO WE REALLY NEED?

There's no universal rule for the optimal amount of capital reserves for construction companies. (See main article.) You want a cash buffer, but too *big* of a buffer could mean you're not investing enough in the operations and growth of the business.

A general rule of thumb for many types of companies is three to six months of operating expenses. With the ups and down of construction, however, you may want to shoot for nine or even 12 months. You'll need to consider various factors, including:

- Typical project size: Contractors that work on smaller jobs with shorter completion times generally need fewer capital reserves than companies that work on large projects with greater upfront costs,
- Monthly operating expenses: Be sure you're well aware of all the cash outlays you must make to stay operational,
- Seasonal fluctuations: You're more likely to need to draw on your cash reserves when business, and therefore cash flow, typically slows down, and
- Risk tolerance: Just like investors, you and your leadership team need to establish how much risk you're willing to take on when managing your money.

When establishing and maintaining a capital reserve account, professional advice is highly advisable. Your CPA can help you generate and analyze well-constructed financial statements that will enable you to set reasonable objectives for your capital reserves.

and, if possible, renegotiate any loans you're paying off. Lining up more favorable terms can translate to more cash, which you can divert to your capital reserves.

Committing to automatic deposits. Adopt a standard practice of direct depositing an established percentage of your monthly sales to a capital reserve account. Be sure to factor the deposits into bids, however.

Improving cash flow management. Overall, savvy cash flow management can go a long way toward making cash reserves a reality. There are plenty of strategies to consider. Automate invoicing to ensure prompt billing. Adopt payment schedules with advantageous terms to hold on to cash longer. Request upfront payments from customers or bill materials to them.

Account maintenance

Once you have established your capital reserve account, it's critical to set and stick to a minimum account balance. Obviously, you can exceed it as much as financially and operationally feasible — up to a certain point. But it's imperative to never stop allocating money to your capital reserves.

In addition, many construction businesses wisely develop formal written policies regarding their cash reserves. Such a policy should, among other things, define strict criteria for authorizing disbursements. It also might require two signatures for any withdrawals or withdrawals exceeding a specified amount.

Peace of mind

Construction companies tend to operate on thin profit margins while being subject to all sorts of risks, not the least of which is bad weather! A healthy capital reserve account can provide peace of mind should times get tough and allow you to seize strategic opportunities more readily when they arise. Contact your CPA for assistance getting started or for help better managing your capital reserves. ■

COULD GO/NO-GO ANALYSIS IMPROVE YOUR BIDDING PROCESS?

For construction companies, bidding is where it all begins. Failing to get it right typically means you either don't win a project that you want to work on, or you wasted time bidding on one that you shouldn't have in the first place. How can you put the odds in your favor?

One approach to consider is go/no-go analysis. It's been used for years by the U.S. military, as well as in engineering and software development. If you want to reduce some of the uncertainty in your construction business's bidding process, you may want to take a look.

Sticking to your strengths

Under the go/no-go approach, you first determine the categories that should be evaluated to define a typically "good" project for your construction company. For example, you've often turned a profit on this type of job, encountered few if any financial or legal disputes, and have done strong work. Common categories include:

- Type of construction (such as homebuilding, commercial or health care),
- Estimated project revenue (for instance, $5 million to $10 million),
- Delivery method (such as conventional bidding or design-build),
- Geographic area (could be a region, neighborhood or proximity to company headquarters),
- Customer identity (for example, a specific developer or commercial entity), and
- State of backlog (that is, how many other jobs you have in the pipeline).

From there, assign points to each category ranging from, say, 5 for "definitely a go" down to 1 for "definitely a no-go." The objective is to create a cumulative score that indicates whether the project in question is truly worth a bid.

To come up with categories and scores, look to historical knowledge of your company and its projects. Don't hesitate to gather your more experienced managers and employees to help recall key details about where you've performed best. Also consider benchmarking to establish "sweet spot" areas for construction companies similar to yours.

Keeping score

Here's how a go/no-go analysis might work. Let's say Jerry owns a general contracting company that primarily builds and rehabs multifamily housing projects, but the business has also worked on some single-family homes and even a couple of smaller commercial jobs.

For simplicity's sake, let's say Jerry and his management team come up with three of the six previously mentioned categories by which to assess forthcoming bids:

1. Project type,
2. Estimated job revenue, and
3. Geographic area.

Because multifamily housing jobs are the company's focus, those types of projects would likely rank a 4 or 5 in the go/no-go analysis. Building a single-family home or working on a manageable commercial project might rank a 3; other, less familiar, jobs would probably rank a 1 or 2.

> The objective is to create a cumulative score that indicates whether the project in question is truly worth a bid.

Historically, most of the company's projects have had estimated project revenues in the $4 million to $6 million range. So prospective jobs that fall in that range would likely be ranked a 4 or 5, while larger projects (which may stretch company resources too thin) or smaller jobs (which may not be worth the effort) would rank lower.

Jerry and his managers decide to rank geographic area using concentric circles of miles. Because lower fuel costs and travel times are optimal, the closer a job is to the company's offices and equipment lot, the higher it'll rank.

Thus, if a project ranked 5 on project type, 5 on estimated revenue and 4 on geographic area, that's a total of 14 points, which would indicate a go. A different job that amassed only, say, 7 points would likely be a no-go. A project that wound up somewhere in the middle, perhaps a 10, might call for further analysis to decide whether to proceed with a bid.

Arriving at a decision

In real life, a go/no-go analysis can include many different categories and dozens, even hundreds, of data points to calculate a result. But no matter how simple or complex the analysis, the objective is the same: To determine whether a given project is worth your while to bid on. ■

CONTRACTORS CAN PROTECT THEIR PEOPLE WITH AN EAP

In an industry known for resilience and toughness, admitting to vulnerability and asking for help often isn't easy. Yet the statistics speak volumes. Construction perennially ranks among the top industries plagued by substance abuse and suicide. Equally troubling, a recent National Center for Health Statistics report found the construction and extraction industries had the highest rate of overdose deaths during 2020.

Industrywide predicament

When not properly addressed, chronic pain, stress, grief, anxiety and depression can fester and worsen. This predicament often leads individuals to self-medicate with drugs or alcohol (or both) and to begin having suicidal thoughts. From a personal perspective, the situation is agonizing and can result in death. From an employment perspective, it tends to lead to diminished productivity, absenteeism and jobsite safety issues.

Insurer CNA has stated that its data indicates prescription opioid use has been greater in

construction than in any other industry. These medications include morphine, codeine, fentanyl, oxycodone (OxyContin®, Percocet®), hydrocodone (Vicodin®) and oxymorphone (Opana®). Medical professionals began prescribing them at higher rates during the 1990s for injuries and chronic pain before realizing how highly addictive they were. You're no doubt aware of the opioid epidemic that's swept the country ever since.

What you can do

What can construction businesses, as employers, do to fight back? One major step to consider is setting up an employee assistance program (EAP).

An EAP is a voluntary and confidential work-based intervention program designed to help employees and their dependent family members deal with issues that may be affecting their mental health, emotional well-being and job performance. By calling a number, opening an app or visiting an online portal, employees and their family members can immediately connect with a professional counselor and receive free assessments, short-term counseling, referrals and follow-up services.

An EAP can be an important component of your construction company's benefits package and overall culture of safety. Along with the critical services it provides, the program essentially serves as a mental health promotion and suicide prevention tool that contributes to an environment in which seeking help is encouraged, not stigmatized — but only if you properly promote it!

Employees must understand that they have free and confidential mental health and substance abuse resources available to them at any time. So, if you decide to implement an EAP, also be prepared to communicate its value. Display posters with crisis hotline numbers and the EAP's contact info on jobsites and in your offices. Distribute wallet-sized cards that employees can carry with them. Regularly publicize the EAP in companywide emails, as well as during onboarding, safety training and in meetings.

Return on investment

Substance abuse contributes to two-thirds of on-the-job accidents across all industries and up to half of workers' compensation claims, according to the U.S. Department of Labor. For employers that invest in EAPs, return on investment is reflected in increased productivity and reduced medical, disability and workers' compensation insurance costs.

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Results will vary, of course. But the positives for your workforce, potential for financial savings and the upgrade to your employer brand are all worth considering. Work with your professional advisors to explore the feasibility of an EAP for your construction company and for help procuring one if you decide to move forward. ■

ABC ON AI: INDUSTRY GUIDE AVAILABLE

Ever since ChatGPT launched in early 2023, an increasing number of people have been using artificial intelligence (AI), or at least more consciously interacting with it. Of course, the business community has been using AI for a while now — some industries more than others.

Construction, a historically slow adopter of new tech, hasn't exactly been on the cutting edge of AI. But legit uses for this technology in the building trade have been widely discussed and some have come to fruition.

Earlier this year, the Associated Builders and Contractors (ABC) released *AI in Construction — What Does It Mean for Our Contractors?* This online publication is essentially a guide for contractors on AI and its expected impact on various aspects of construction. Here's a brief summary of what it covers:

Definitions. To actively participate in conversations about AI, construction business owners and their leadership teams will need to familiarize themselves with the terminology. The ABC guide kicks off with a short section clearly defining common terms, such as:

- Deep learning, a subset of machine learning that simulates the behavior of the human brain,
- Generative AI, interactive technology that can generate content,
- Predictive AI, algorithms based on machine learning that forecast future events or trends.

Project lifecycle impacts/examples. This section explains how different tasks within the project lifecycle can benefit from AI. It lists and links to AI tools that can be used during preconstruction,

construction and building maintenance phases. Readers may recognize some brands and products, such as Autodesk® and Procore Copilot®.

HR office considerations. The guide provides best practices in drafting ethical AI policies and guidelines. For instance, it advises HR representatives to ask specialized questions about how employees plan to use the tech in the office.

It further explains that, before laying out a blanket policy, construction businesses should clearly define the purpose of their AI usage policies. Such policies may include what AI technologies are covered and how the policy applies to employees and outside stakeholders: "Consider an overall approach that monitors AI use and encourages innovation but ensures that AI is only used to augment internal work and with proper data," says the guide.

Conclusion. The report closes with a brief analysis of the current AI landscape in construction and an industry recommendation to continue pushing toward becoming a digital workforce. Says ABC Director of Construction Technology and Innovation Patrick Scarpati, who authored the guide:

> The industry has immense opportunities to evaluate how we can better deliver projects, and we can lean on AI in achieving essential goals like upskilling, workforce development, knowledge transfer, supply chain optimization, enhanced safety design and planning and much more.

To read ABC's AI guide in full, visit abc.org/ai. ■

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About Wouch, Maloney & Co., LLP

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