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Wrangling with the reality of retainage

Retainage has long been a contentious practice in the construction industry. Unfortunately, it appears unlikely to disappear anytime soon. The good news is that by recognizing and planning for the negative impacts of retainage, you can reduce the risk to your business's financial performance.

Owner's benefit

In a typical retainage scenario, the project owner withholds a certain percentage of earned revenue (typically 5% to 10%) until completion or the achievement of certain milestones. Theoretically, doing so helps reduce the risk that the general contractor won't complete the job according to the construction agreement. It effectively shifts the negative financial impact of disputes, delays, mistakes or outright failure from the owner to the contractor.

In the eyes of owners, retainage also incentivizes construction companies to perform at a high level. And it creates some breathing room to pursue dispute resolution or litigation when necessary.

Multiple downsides

From a general contractor's perspective, retainage could offer a potential upside: It can sometimes eliminate the requirement to obtain a performance bond, letter of credit or similar financial guarantee. However, the downsides usually far outweigh this perk.

Perhaps the most obvious adverse impact relates to cash flow. Retainage makes it harder to cover the costs of materials and labor, as well as manage other expenses necessary to keep a project on schedule. As a result, most construction businesses must either have substantial cash on hand or the ability to secure financing. (See "Protect your company with a retainage reserve" on page 3.)

The strain can be particularly difficult for contractors working on large projects or multiple jobs simultaneously. And it's often exacerbated when owners delay release of retainage, which typically occurs because of an oversight, dispute or slow accounts payable practices.

Retainage also creates administrative headaches and complicates accounting. It requires careful tracking of project progress so the contractor can determine and support when retainage should be released. In addition, contractors need systems in place to promptly notify owners of upcoming retainage release obligations — and formally follow up if funds remain withheld.

4 risk management measures

As mentioned, your hands aren't completely tied when dealing with retainage. Here are four risk management measures to consider:

1. Replace retainage with retention bonds. In some cases, rather than having a percentage of payment(s) withheld by the owner, you can buy a bond and name the owner as the beneficiary. The owner receives comparable protection with fewer administrative burdens, while you receive full payments. This assumes, of course, that the bond

Protect your company with a retainage reserve

Financially sound construction businesses often rely on cash reserves to protect against emergencies, unpredictable economic conditions and the industry's cash flow challenges. If your company regularly encounters the negative consequences of retainage (see main article), consider establishing a dedicated retainage reserve. It can provide financial relief when retainage payments are delayed or tied up in a prolonged dispute.

To get started, open a bank account specifically for a retainage reserve. High-yield business checking accounts often work well because the accumulated funds will earn at least some interest. But shop around and see what works best.

Next, sweep a defined percentage of revenue from each project into the account. If you already have a general cash reserve, consider transferring some of those funds into the retainage reserve to raise its balance more quickly. Set a goal for the desired reserve amount, so you're not diverting funds indefinitely. Maintain the account carefully, replenishing it as necessary and safeguarding against fraud.

premium is less than the owner's desired retainage amount and your construction company financially qualifies for the bond.

2. Refine contract language. Don't cut corners when drafting contracts or rely on outdated agreements. Many disputes arise from disagreements about scope or performance standards. Use clear, unambiguous language when defining retainage terms — especially "substantial completion" — and conditions for release.

Documenting owners' acknowledgments of satisfaction with your work can be particularly valuable.

You also might want to restrict how retainage funds may be used. For example, can they compensate the owner for workmanship defects? If your company has a strong track record of delivering high-quality work, you might be able to leverage it to negotiate more favorable terms, such as the release of retainage at key milestones rather than on completion.

3. Document, document, document. Keep detailed records of job progress, payments received and communications regarding retainage. Documenting owners' acknowledgments of satisfaction with your work can be particularly valuable. Additionally, closely track change orders and any other occurrences beyond your control that trigger delays.

4. Wield relevant laws to your advantage. Make sure that you, your leadership team and all your project managers are well-versed in applicable state and local retainage laws. Depending on the jurisdiction, governing bodies might impose retainage caps, escrow requirements and release timelines. Also investigate the interplay between retainage and mechanics' lien laws.

Great help

Wrangling with retainage isn't easy. However, it's far better to recognize the risks and develop coherent strategies for managing them than to look the other way. Your professional advisors can be of great help. For instance, work with your attorney to fine-tune contracts and fully understand your legal rights. Meanwhile, ask your CPA for assistance with job costing and ascertaining the true financial impact of retainage. ■

How to run a more profitable construction business

Running a successful construction company obviously requires quality workmanship and timely project completion. However, it's also critical to ensure every job contributes to your business's long-term financial health — and that means operating profitably. Let's review some fundamental ways to do that.

Learn from estimating history

Your company's estimating history contains a wealth of data. Review completed jobs, both profitable and unprofitable, from a recent period. Compare each job's estimate to the actual figures and investigate any significant discrepancies. Ask yourself questions such as:

- Were job costs accurate?
- Were assumptions about labor and materials requirements reasonable?
- Was the crew as productive as it should have been?

Document your findings and refer to them when creating future estimates.

Identify indirect costs

The only way to know whether jobs are profitable is to understand their true costs. That means having a system that accurately captures, classifies and allocates direct *and* indirect costs.

Most contractors do a good job of identifying direct costs, such as labor, materials, equipment and subcontractor payments. But indirect costs are equally important. Not to be confused with overhead, these generally include expenditures associated with more than one job (such as workers' compensation insurance) and costs indirectly related to jobsite activities (such as payroll service fees). Your CPA can help you identify more examples.

Micromanage markup

Including a profit cushion in your bids helps protect against the inherent uncertainties of the construction process. The optimal amount of a markup depends on the characteristics of your business, the size of your projects and other factors, such as job-specific risks.

Review and adjust your markup regularly. If it's too high, you may lose jobs; if it's too low, you may take on too much risk. Consider using different markup percentages for different line items. For example, labor, which tends to be uncertain, may require a higher markup than materials and subcontractor expenses, which generally are more predictable.

Leverage preconstruction

Preconstruction is often an undervalued aspect of the building process. Review all project documents carefully before you break ground. Ensure everyone involved understands the job's objective and scope. Set a realistic schedule that accounts for the possibility of unforeseen circumstances, such as bad site conditions, inclement weather, and owner-driven changes or additions.

Speaking of which, make sure you have procedures in place for identifying scope changes, documenting those developments and quickly processing a change order. Missing or mishandled change orders represent lost profit-enhancement opportunities.

Track job financials

Construction is fraught with uncertainty. No matter how well you plan, changing circumstances during a project can significantly affect costs, cash flow and profit. Rather than wait until a job is complete to assess the damage, it's critical to prepare and monitor work-in-progress (WIP) reports to track financial performance during the project.

Doing so allows you to identify problems while there's still time to address them. For example, WIP reports that indicate declining gross profits or underbillings may reveal poor estimating, inefficient project management, lax billing practices or other weaknesses.

Beware of scope creep

If you've been in construction for a while, you're probably familiar with scope creep. This happens when the actual work performed on a job gradually expands beyond the contract parameters — without compensatory change orders.

Again, generating WIP reports and other financial documentation should enable you to stay on top of unexpected cost increases. However, train project managers to closely monitor what's happening on the jobsite, too. Of the tasks being completed, are all of them covered under the contract? It's not unusual for owners to ask for little extras that lead to scope creep.

Finish in the black

As you're no doubt aware, profitability is hardly a given in the construction industry. When these and other best practices become a part of your company's routine and culture, you'll give yourself a fighting chance to finish in the black. ■

The power of preconstruction

When most people think about construction, they likely picture a busy jobsite bustling with workers, heavy equipment and trucks delivering materials. But those in the business know that the success of most projects is often determined before a single boot hits the jobsite. That's the power of preconstruction. Mastering it is essential to controlling costs and protecting your profit margin.

Why it matters

Preconstruction is the essential planning phase between winning the bid and starting work. It should cover everything from assessing project-specific variables to setting the budget to creating a schedule that coordinates everyone's work smoothly. When done right, preconstruction minimizes surprises, prevents or reduces delays, and provides a roadmap that all project participants can follow to completion.

As you may have experienced, this stage can make or break a job's bottom line. Do it right and you'll identify risks going in and, ideally, manage them before they turn into costly problems. You can also seize the opportunity to double-check your estimates, get familiar with the schedule and allocate all your resources — human and otherwise — for optimal results. Ignoring or failing at preconstruction raises the threat levels of budget overruns, wasted time and unhappy owners.

Key measures

The good news is you don't need to reinvent the wheel to improve your company's distinctive preconstruction process. Assuming you've already been engaging in some pre-project planning, you can build on those practices. Here are some key measures to consider:

Develop a thorough project assessment procedure. It should include specific steps for analyzing site conditions, researching weather forecasts, fulfilling permitting requirements, assembling the labor team, and projecting and addressing potential supply chain issues.

Check and recheck financials. In a volatile cost environment, you can never assume the figures you started with will be accurate as the project progresses. As mentioned, a key part of preconstruction is reviewing your estimate against current market conditions. You may need to revise financials based on more realistic labor and materials costs. Involving subcontractors and suppliers early often leads to more reliable data and fewer surprises down the road.

Involve project owners. Often, and perhaps understandably, owners want work to start as soon as possible after the contract is signed. To the extent possible, slow their roll and sell them on the importance of preconstruction. Many disputes and delays stem from the seeds of misunderstandings planted early on. Take the time and nurture the communication skills necessary to walk owners through budgeting, design approval, scope details and scheduling.

Invest in software (or at least checklists). If you haven't already done so, explore the feasibility of preconstruction software for your company. Multiple developers now offer platforms that automate the entire planning process, so it's standardized and efficient. If you're not ready for such a purchase, create checklists that your project teams can follow to ensure consistency.

Practice makes perfect

For today's small to midsize construction businesses, profit margins are typically too thin to leave anything to chance. Even modest improvements in preconstruction can translate into better budgets, more sensible schedules and fewer delays. In turn, you should see substantial cost savings and a stronger bottom line. ■

A construction technologist may help some companies

New technologies are rapidly reshaping how construction companies plan, manage and deliver their projects. However, with so many choices — and the ever-present risk of wasting money on ineffective solutions — many construction businesses struggle with how to proceed. A construction technologist may help bridge the gap between cutting-edge innovation and day-to-day realities.

Practical knowledge

A construction technologist is a management-level employee who combines top-flight tech competency with a demonstrated, practical knowledge of construction processes. The job description tends to vary based on a business's distinct needs, but it generally includes:

- Monitoring the technology budget,
- Addressing pain points experienced by office and field staff, and
- Finding opportunities to increase efficiency.

Among the most important skills for a construction technologist to possess is the ability to research, procure, test, and launch new systems and software that enhance operations. These days, that likely includes evaluating what role artificial intelligence should play in the business.

Serious decision

Hiring a high-level employee like this is a serious decision. Construction technologists typically command a substantial salary plus benefits. Plus, this individual will be another voice on the leadership team. You must be ready for that. Deciding whether the position is worth adding to your company will depend on your strategic goals and capacity for growth.

Start by forming a committee composed of company leadership and your most tech-savvy employees. Task the committee with reviewing your technology use and answering questions such as "What are our tech priorities?" and "How do we expect our operations to change in the next three to five years?"

These days, a construction technologist will likely evaluate what role artificial intelligence should play in the business.

You should also look at your current tech challenges. What systems, software and apps do you currently use? How often do you use them? What's working — that is, saving you time and money or otherwise adding value — and what's not?

From there, explore the likelihood that better solutions are available. And if so, why aren't you using them? Maybe they're difficult to identify, or you're unsure how to choose the best product and implement it properly.

Your committee might find that your current tech solutions and capacity to improve them are sufficient or just need some enhancement. On the other hand, it could discover a deeper need for better understanding and managing technology.

Big move

If your leadership team needs a voice to champion and guide tech-related decisions, a construction technologist could provide the expertise to move your business forward with confidence. Then again, as mentioned, it's a big move with significant cost implications. Your professional advisors can help you weigh the pros and cons. ■

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- We develop **relationships with lenders and bonding agents** and understand how to present your financial picture in their preferred format.
- We assist you in **keeping a close eye on debt, cash flow, profit margins** and other measures of financial health.
- We prepare **contracts in progress** schedules that management can understand which clearly illustrate gross profit, job costing and over/under billings per job.
- We have highly trained staff with **expertise in construction accounting** who are detail oriented, but who do not lose sight of the larger goal which is to provide our clients with quality services to meet their many financial needs.

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