Best Practices
By Garrett J. Sullivan

Cash Flow: The Oxygen of Business

Just as an asthmatic can think of nothing but oxygen during an attack, your business fights for breath when cash runs low. We all know what happens when a person goes without oxygen for too long. The same is true of any contractor, large or small, when their financial "oxygen" is cut off.

Even if all of your jobs are making a profit, you can still run out of cash. Cash flow and profitability are different financial measurements. If you're not tracking your financial statements each month, start today. Check by deducting your accounts receivable from your total billings and accounts payable from the total cost of earned revenue. The result should be positive and not negative.

Check this figure every month as a Key Performing Indicator. Meanwhile, below are eight "health tips" to keep your oxygen flowing.

1. Protect Your Immune System: Prepare the Right Bid
Positive cash flow starts with your bid proposal and additional provisions. State the amount of retention you are willing to accept. If you are bonding the project, demand zero retention or at least negotiate it down to 5% to start and 2.5% when half of the job is completed.

If you're a subcontractor, mirror the General Contractor's (GC's) retention. If your work as a subcontractor starts at the beginning of a long job, insist on being paid 45 days after the Owner has paid the GC for your work. This saves you from waiting until the job is finished – and chasing a GC who has no sense of urgency to close the project.

Insist that your bid be attached to the subcontract as an exhibit and that it take precedence over any conflicting terms. Include a termination date (I recommend using the new labor wage rate date). This allows you to renegotiate at the higher labor cost should the project be delayed. Subcontractors should give their best pricing to GCs who pay on time and professionally manage their jobs. Second-tier pricing should be given to less desirable GCs.

Remember, you only have one time to include your contract terms.

2. Understand Your Medication: Read the Small Print

Read your contract and/or subcontract very carefully. Don't be embarrassed if you don't understand it; ask someone who does. An enormous amount of risk can be transferred to you as a GC/subcontractor when you indemnify owners, architects, or engineers. Understand whether you are agreeing to buy additional insurance, at your own cost, prior to signing the contract – not afterwards. Make certain that the final contract mirrors the actual amount of your bid, without any hidden extras that can kill your profit – and possibly your entire business. Quite simply, if the terms are stacked against you, correct them or walk away from the job.

3. Vaccinate Against Future Disease: Collect Payment ASAP

Now that you've ensured your payment terms are reflected in your contract, draft an invoice well ahead of the due date to shake out any payment delays. Be a savvy contractor and front load your invoice. Just be sure the Owner/GC approves your payment quantities before submittal.

Your accounting department must act quickly to learn which documents will be required and when. Gather those documents (e.g., an approved schedule of values, lien releases from suppliers, tax and union clearances, etc.) well ahead of time. Have your project managers/engineers report the quantities early. These "minor tasks" can chew up days or weeks when your accounting department is still learning the new billing process. Once that all-important first invoice is ready, hand deliver it.

I like to call the next step "Dialing for Dollars." We all know that getting paid in construction is much different than other businesses, so it literally pays to be persistent. Assign the person in your accounting department who has the best personality to phone the Owner/GC each week to check the status of your payment. Have this person mark the payment status on an Accounts Receivable Log which you review weekly. For a free downloadable example, go to www.sullivanhi.com.

While some contractors only make these calls after the payment is late, proactive calls are like running five miles every day to improve your breathing rate. Your cash position benefits immensely because you are checking on your payment status each week.

4. Avoid Pneumonia: Judiciously Manage Change Orders

Standardize the change order process and demand it be rigidly followed. This is a key area that can hurt cash flow. Under no conditions should a GC/subcontractor proceed with extra work unless it is approved in writing ***by a person with authority to bind the contract***.

Have a signed change proposal followed by a contract change order. If it is a field order, the extra work should be priced out ASAP and the proposal signed. Avoid allowing the Owner/GC to lump several items into one change order in the name of efficiency. Remember, this is your money that you never planned to lend. You are not a bank to be used by others to finance their jobs. Ensure that your field personnel watch this closely by incentivizing change order management to their bonus/compensation.

5. Stop Inflammation: Don't Grow Too Quickly

Contractors love to brag about the volume of business they complete, but keep in mind: growth requires cash. If you are a $5 million contractor and grow to $10 million in a single year with 10% retention, you have just tied up $500,000. Grow, but grow wisely. Remember, "Volume is for vanity, profit is for sanity."

6. Take Your Vitamins: Pay Suppliers Quickly

On-time payments to your suppliers are critical if you expect to receive the best pricing. Be aware of any supplier discounts for early payments, and direct your accounting department to take all discounts offered. Have them note the recurring monthly pay dates. These discounts drop directly to your bottom line.

An extra bonus is that your suppliers will be much more willing to help you in the future, should you have difficulties. They need cash flow too, and will remember your consideration when you need a favor from them.

7. Have a Nebulizer: Establish a Rainy Day Fund

In order to be ready for the next possible "asthma attack," maintain a Rainy Day Fund. This is money you regularly set aside, usually in a money market or CD, for emergencies. I recommend at least six months of office overhead for the Fund. Let's say there is a labor strike and you can't cross picket lines. If you still carry the direct costs of the job, you will need immediate access to cash for the duration of the strike. The number of possible scenarios is endless, but the idea is the same – eventually it always rains. A Rainy Day Fund prepares you for anything – material shortages, fires, earthquakes, tsunamis, electrical outages, etc.

Avoid the temptation of diverting Rainy Day Funds by taking large cash distributions for planes, trains and boats, as opposed to need-to-have necessities outside the business.

8. Store Up Antibiotics: Have A Line of Credit
All contractors should have a line of credit at the highest possible limit in order to survive the peaks and troughs of payment cycles. Even if you don't need it, use your line of credit at least once a year so your banker knows you will pay it back responsibly. Increase the amount each year, as this will be nearly impossible to accomplish when you will need it the most – during a financial crisis.

In summary, successful contractors realize they are a business first and a construction company second. All Best in Class Contractors take the above steps. That's why the Construction Financial Management Association (CFMA) 2010 Annual Survey revealed the Best in Class Contractors' average net earnings before taxes was 6.5% vs. 3.5% for all others. Cash will always be king in business, and a prudent contractor will always monitor cash flow to ensure optimum health.

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