

# Construction

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# A blueprint for strong cash flow

**C**ash flow is the lifeblood of any business, but it's particularly critical for construction companies. And, in today's economy, the construction industry's typically modest profit margins are even thinner than usual. That's why it's essential to lay a solid foundation for healthy cash flow, starting with the contract. In many cases, it's possible to negotiate contract terms that can accelerate the flow of cash.

## Pay attention to payment terms

Payment terms have an enormous impact on cash flow. A contract that calls for payment on completion of specified phases of the project, for example, creates uncertainty, making cash flow forecasting difficult. A contract that requires payment in equal installments over the course of a project provides greater predictability but may not correspond to your expenditures on the job.

It's not unusual for a construction project to involve significant upfront costs. If possible, negotiate a "front-loaded" billing schedule that reflects your greater cash needs in a project's early stages. You might also ask for accelerated payment methods, such as wire transfers or electronic checks.

## Limit retainage provisions

A 5% or 10% retainage can easily defer your entire gross profit on a job until after construction is completed. To reduce the impact on your cash flow, try to negotiate a lower percentage or ask for retainage to be phased out over the course of the project. For example, the contract might provide for 10% retainage, reduced to 5% when the job is 50% complete and eliminated when it's 75% complete.

Other options include limiting retainage to certain job costs, such as the labor component, or eliminating it altogether through the use of letters of credit, performance bonds or other security.

## Get change order procedures in order

As you know, change orders are an inevitable part of most construction jobs. It's critical that your contracts establish clear terms and procedures for approving and paying them.

If your contracts don't have such terms, your payments may be delayed for additional work. Or, even worse, you might lose out on those payments altogether.



## Don't let requisitions wreck you

It's not unusual for a contract to disallow requisitions for materials until the materials have been installed. To avoid cash flow disasters, try to negotiate requisition terms that allow you to request payment once materials have been delivered to the job site.

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## Look both ways

Remember that cash flows in two directions, and outflow is just as important as inflow. (See "9 cash-flow management tips" at right.) Scrutinize your contract terms with vendors, suppliers and subcontractors. You may be able to avoid cash flow problems by negotiating payment terms that, to the extent possible, match your cash outlays with your receipts from the owner or general contractor.

For example, include retainage provisions in your subcontracts that have terms similar to those in your contract with the owner. If you're a subcontractor and your contract with the general contractor contains a "pay-when-paid" or "pay-if-paid" clause, your contracts with sub-subcontractors should contain parallel provisions. That way, you won't be forced to pay subs until you collect from the general.

## Watch your language

Because contract terms can have a significant financial impact on your bottom line, you must review the language in all your contracts with an eye toward forecasting and managing cash flow. Whenever possible, negotiate terms that will enable your firm to maintain a healthy cash position throughout the life of each job. ■

## 9 cash-flow management tips

Although healthy cash flow begins with a carefully structured contract (see main article), there are several more ways you can avoid cash flow problems. Among other things, you should:

1. Assess the financial strength and creditworthiness of the owner as well as other contractors, suppliers and vendors,
2. Prepare cash flow forecasts and make any necessary adjustments during the course of a job,
3. Monitor work-in-process reports, cash flow reports and other documents to spot cash flow issues while there's still time to do something about them,
4. Make sure your project management team submits paperwork and issues invoices on a timely basis,
5. Develop working relationships with customers' accounts payable personnel, staying in touch to ensure payments are on schedule rather than waiting until a payment is past due to contact them,
6. Establish clear procedures for your personnel to identify changes in the scope of work and to promptly prepare and document change orders in accordance with contract terms,
7. Not make payments to subcontractors, suppliers or vendors any earlier than required unless you're entitled to a discount for doing so,
8. Tie bonuses or other incentives to effective cash flow management, and
9. Use sweep accounts or zero-balance accounts to maximize investment returns on your funds.

These are just a few ideas for staying on top of cash flow during a project. Whichever strategies you adopt, your employees must understand the critical role that cash management plays in your company's success.

# Don't let profit fade wipe out your bottom line

**M**any construction projects fall prey to what's known as "profit fade." In many cases, this costly problem comes into play when a job goes awry, taking with it the expected profit margin.

Most contractors have a good idea of how this can happen. For example, an owner goes change-order crazy or a job extends way beyond the scheduled finish date. So the question is: How can you prevent profit fade from wiping out the bottom line on your next project?

## Expect the unexpected

The profit you calculate when bidding a job can fluctuate dramatically as work progresses. For every phase you finish under budget, there may be an unexpected problem waiting to wipe out the savings. If you want to end at the top of the arc, you need to stay on top of each project's swings.

Every significant cost increase should be accompanied by a change order that increases the value of the contract. If it isn't, determine why. Was your initial estimate off? Or have you done extra work that wasn't covered by a change order? In either case, you're headed for profit fade, and you need to find ways to get the job back to "profit friendly" status.

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*Before work begins, understand fully what you're contracted to do.*

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## Do your homework

In addition to monitoring works in progress, study your estimating and profit histories. Review some good jobs and some that didn't work out so well



to determine where the jobs didn't meet budgets and whether expenses were allocated properly.

Discuss with your supervisors whether the assumptions you used in estimating the projects were valid. Did you, for example, realistically calculate the number of bricks your crews could lay in a day? Were your average labor costs accurate?

Also consider direct and indirect costs, and compare your estimates on jobs that lost money to those you used on profitable projects. Then use the results to improve estimating procedures on future projects. If, for example, projects were delayed because you expected your project manager to obtain final foundation design approvals and shop drawings while also getting the job under way, you may need to revisit your staffing estimates.

Look, too, at whether certain owners cost you money. If one owner consistently moved walls

or added doors, you may want to be sure any future contracts with that owner include specific language regarding scope and specification changes, change orders and schedule revisions.

### Make the contract clear

Before work begins, understand fully what you're contracted to do. Contract language is often unclear, resulting in differences in interpretations that can disrupt and delay projects. Conducting a careful review of the contract and clarifying any uncertainties at the start of the job can help prevent disruptions and delays going forward.

Also make sure your project managers understand the contract language fully. Meet with them before every project to discuss not only the contractual provisions for scope of work and change orders, but also what you bid and why.

As work progresses, meet with your project managers regularly to make sure they're comparing their actual costs to the bid cost amounts. If a problem

arises, they can address it with the owner immediately. They should also note the reason for the issue. For example, if you're typically plagued by weather delays during a certain time of year, you may need to build a little more time into your bids.

If there's a problem, remember that your leverage is strongest *before* the project is finished. Owners need your help to meet their goals, and they may be more amenable to approving change orders while you're still on the job. If you wait until the project is done, an owner will have use of the facility and may not release your retainage. In other words, they're holding all the cards.

### Make profit fade fade away

Profit fade can be perilous to any size of construction company. It's simply something you can't ignore. But there's an upside to proactively combating profit fade: By adhering to the advice offered in this article, you'll make your surety more confident in your ability to make a profit. ■

## Structural engineering

How separate entities can strengthen your firm

**M**ost contractors put a lot of thought into the optimal business structure for their companies. Each form of business — whether it's a sole proprietorship, C or S corporation, limited liability company (LLC), or partnership — offers different advantages and disadvantages. But have you considered the potential advantages to operating segments of your business through *separate* legal entities?

### Reducing risk

Construction companies have been hit particularly hard by the nation's economic struggles. To stay competitive, many are taking on new types of work. Some are tackling larger projects, while others are pursuing government work or developing new niches.

Stepping out of your comfort zone can be a great way to expand your business, but it also involves additional risk. For example, getting involved in work with which you have little or no experience



presents a greater danger of construction mistakes or estimating errors. Setting up a separate legal entity for new lines of business can help shield your core business's assets against liability for these risks.

## Tax planning

Setting up separate entities can also be advantageous tax-wise. Here are some examples:

- A contractor who establishes a separate leasing company to supply equipment for construction jobs may be able to defer sales and use taxes until he or she actually uses a piece of equipment on a job.
- A contractor who sets up a separate transportation company to deliver materials and equipment to job sites may enjoy sales and use tax exemptions for purchasing, leasing and maintaining certain vehicles.
- A contractor who qualifies for the manufacturers' deduction (also referred to as the domestic production activities deduction or Section 199 deduction) may be able to maximize the deduction by forming a separate entity to perform qualifying construction projects.

The availability of many tax planning opportunities depends on applicable state or local laws. Consult your tax advisor to determine whether you qualify and, if so, the steps you'll need to follow to secure these tax benefits.



## Succession and estate planning

Establishing a separate entity can also work in succession and estate planning. Suppose you have three children, only one of whom works in your construction company. You want to provide equally for all three children, but most of your wealth is tied up in the business. And providing a share of the company to the two children who don't work in the business may not be fair to the one who does. What's the solution?

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If your business owns its building and land, one option is to create a separate entity to hold the real estate and lease it back to the company. This enables you to transfer ownership interests in the real estate to the children who don't work in the business and an ownership interest in the company to your successor.

## Increasing bonding capacity

In some cases, contractors that set up separate entities for different lines of business or to hold real estate or equipment can enhance the bonding capacity of their core businesses. How? By moving certain assets and liabilities off their balance sheets.

Keep in mind, however, that accounting standards for "Variable Interest Entities" may make this strategy more difficult. Under certain circumstances, the standards require these entities to be consolidated into the contractor's financial statements.

## Keeping it real

When using separate entities to achieve liability protection and tax savings, it's critical to properly capitalize and structure them and to operate them as legitimate, separate businesses. Otherwise, the IRS, a state tax authority or a creditor might claim that the entity is a sham and attempt to undo the benefits. ■



## Getting to the job: Transportation or commuting?

**F**ew areas of tax law are more confusing than the distinction between deductible *transportation* expenses and nondeductible *commuting* expenses. This issue is important for contractors and construction workers, who often travel from home to one or more temporary job sites or who use a home office as a base. Here's how the IRS sees it.

### Deductible vs. nondeductible

Generally, the cost of getting from home to work is a nondeductible personal expense. Once you're there, work-related transportation costs — for travel to or between job sites, for example — are deductible business expenses.

But what if you and your construction workers each travel directly from your respective homes to a job site? Would it be a deductible or nondeductible expense? The IRS has provided some guidelines. You're allowed to deduct the cost of:

#### Transportation between your home and a temporary work location outside the metropolitan



**area in which you live and normally work.** In general, a job site is temporary if your employment there "is realistically expected to last (and does, in fact, last) for one year or less." A job of indefinite duration isn't temporary.

**Transportation between your home and a temporary work location, regardless of distance, if you have a "regular work location" away from home.** If, like many construction company owners (and workers), you have no regular work location outside your home, you can't deduct transportation expenses from your home to your first job of the day or from your last job to your home.

**Transportation between your home and other work locations, if your home qualifies as your "principal place of business."** These expenses are deductible regardless of distance and regardless of whether the job site is temporary.

These guidelines are helpful, but they also raise several important questions. For example: What is your metropolitan area? Is a particular job temporary or indefinite? Do you have one or more regular work locations? Does your home qualify as your principal place of business?

### Substantiation is key

The answers to the above questions often require interpretation of the Internal Revenue Code, tax regulations and court opinions. So it's important to consult your tax advisor to be sure that you claim any deductions to which you're entitled. In addition, whether or not a job is temporary depends on the expectations of the parties, so it's also a good idea to substantiate these expectations — through written agreements, correspondence or other documentation — whenever possible. ■