



## CASH FLOW MANAGEMENT STRATEGIES



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Cash management is very important for construction contractors due to the inherent high risk nature of the business. Although cash management can be difficult for construction companies because of the large outlays of cash that must be made before revenue is generated, it is critical to the company's operations.

The lack of effective cash management is a factor in the high rate of insolvencies in the construction industry due to:

- Economic trends
- Fluctuations in interest rates
- Volatile demand for residential and commercial construction
- Rising cost of land and materials
- Local restrictions on construction
- Lengthy entitlement or permit processes
- Environmental regulations

### CASH MANAGEMENT SYSTEM

Proper cash management can not be achieved without an effective system. A cash management system must be able to determine the cash flows from operations. From that information management can assess the company's ability to meet its financial obligations and generate future profits and cash flows. In addition, a cash management system should be able to assist management in determining the amounts to invest in property and equipment.

Effective cash management systems have to include planning, budgeting and forecasting, as well as proper billing and collections procedures. Follow-up and revisions to cash projections must be done on a regular basis in order for the information to be meaningful. In addition, the system should be fully integrated with internal bidding, estimating and job costs systems.

The job planning process begins with the bidding and contract negotiations and continues as jobs are scheduled and materials are purchased. Cash forecasts should be prepared monthly or quarterly for all jobs. This requires the company to schedule each phase of construction and then plan for the timing of disbursements and cash receipts from progress billings based on contract terms. These individual job cash forecasts can then be combined into a cash flow forecast for the company.

The company forecast should also include non-job-related cash flows for items such as general and administrative expenses, interest income and expenses, expenditures for property and equipment, and

income taxes. This approach will highlight periods where cash flows will be insufficient and cash requirements will need to be met by the company's cash reserves or by credit facilities. It will also give management the opportunity to discuss potential issues with their banker and/or surety agent before a situation becomes problematic.

#### TYPICAL CASH FLOW COMPONENTS ON AN INDIVIDUAL JOB BASIS

Each construction job or project should be set-up as a separate profit center. Typical components of cash receipts and disbursements for these profit centers are:

##### Individual Job Based Cash Flow

###### *Cash Receipts or Income*

Billings (less retentions)		\$xx
Retentions (paid upon completion and acceptance)		xx
Claims and Change Orders		<u>xx</u>
Total		<u>\$xx</u>

###### *Cash Disbursements or Payments*

Bid Costs		\$xx
Preconstruction Costs (engineering, architectural design, etc.)	xx	
Materials and Supplies	xx	
Equipment (purchase, lease or rental)		xx
Payments to Subcontractors		xx
Labor		xx
Overhead		xx
Disputed Items/Claims	<u>xx</u>	
Total		\$xx

*Net Cash Flow* \$xx

Contractors that understand and can properly project cash receipts and disbursements on an individual job basis will increase their overall profitability. The goal is to accelerate the cash receipts and minimize negative cash flow for each project. To do this, a contractor should plan to receive payments from the owner before he needs to disburse money to subcontractors, laborers, suppliers, etc. This can be difficult because of owner retention clauses in construction contracts, as well as delays in change orders and disputes.

Once an effective system is in place for managing cash, the company can use some additional techniques to accelerate cash flow from a project and minimize financing costs, especially if favorable terms are negotiated.

#### BILLING

Billing terms which should be considered in contract negotiations are as follows:

- Front loading contracts by assigning a higher percentage of the contract price to the segments which are completed early in the construction process.



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- Payment for materials purchased and stored prior to installation.
- Procedures for payment of change orders.
- Retentions – should be negotiated in contracts to minimize the effects on cash flows by agreeing to the release of retentions when construction is completed. Typical retentions of 10% can be as much as the entire gross profit on a job. Contractors can try to negotiate:
  - Lower percentages for retainage.
  - Limiting retention to the labor element of the contract.
  - Reducing retention percentage to 5% after the job is 50% complete.
  - Eliminating retention by providing performance bonds and/or letters of credit instead.

Billings should be followed by appropriate collection procedures. This is important during a recession or period of high interest rates when slow payments are the norm. Especially because it becomes more expensive to carry accounts receivables in terms of real dollars.

#### CASH DISBURSEMENTS

- Retentions payable to subcontractors should be on the same terms as your contracts with the owner or developer.
- Accounts payable procedures should be setup to take advantage of purchase discount terms of 1% or 2% for payment within a specified period. These discounts can reduce the job costs, as well as other operating costs.
- Payments to service providers are usually due in 30 days. These invoices should not be paid early unless there is a discount for early payment such as 2-10 net 30.

#### CONCLUSION

Contractors with individual job based cash management systems that forecast the timing of receipts and disbursements are more likely to be profitable. Contractors should work with their accountants to insure that their cash projections for each job are as accurate as possible. Individual job cash forecasts can then be combined into a cash flow forecast for the company. Cash management must be an integrated system which is constantly monitored to ensure the financial stability of the company.

As one of the leading accounting and consulting firms for the construction industry, Cowan, Guteski & Co., P.A. works closely with our clients to help them develop effective cash flow management and accounting systems. Contact Bill McNamara, CPA - Director of the Construction Services Group at 732-349-6880 extension 116 or [bmcnamara@cowanguteski.com](mailto:bmcnamara@cowanguteski.com) for more information on value-added strategies that can help you become more profitable.



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