MONEY MANAGEMENT:
Techniques for the contractor

Effective money management is essential for both established and new contractors.

(This article was written by Edward J. Harrington, Partner and National Services Director for Construction, Touche Ross Co. Although written primarily for general contractors, the advice is applicable to wall and ceiling contractors-and the section on subcontractors’ payment clauses makes for good advance warning.)

The construction industry has long been characterized as one of easy entrance and, unfortunately, quick exit. With minimal cash, an individual or group of individuals can form a construction company. However, because most of these companies operate from a tight cash position, one adverse event, such as a significant cost overrun on one job, can put existence in jeopardy. To overcome the dangers and limitations of a minimal cash investment for operations, careful, effective cash management is essential for both established and new contractors. Successful contractors have developed techniques to manage cash received from their initial investment, from profitable jobs and from sources unique to the construction industry.

The most common and effective money management techniques used by contractors are front-end loading and income tax deferral. Other techniques and tax practices, effective but perhaps more subtle, include programming cash-flow activities, avoiding excessive investment in equipment, payment clauses in subcontractor agreements, managing material billings, maximizing investment-credit benefits, and supervising effective, rapid completion to accelerate retainage collection. This article will briefly examine these practices and discuss their implications for the contractor.

Front-End Loading

Perhaps the most frequently used money-management technique is front-end loading. As a means of cash management it is unique to the construction industry and, when carefully implemented, can be a source of interest-free funds.

The process is relatively simple. When a contractor is selected as the low bidder on a job, he must prepare a trade-payment breakdown as the basis on which he will be paid while work progresses. In front-end loading, the contractor “unbalances” the trade-payment breakdown as it relates to costs incurred on the project. The following schedule, which artificially assumes that each listed phase of the job will have a similar cost, illustrates this concept.

<table>
<thead>
<tr>
<th>Job Phase</th>
<th>Estimate Used For Bid Submission</th>
<th>Amounts Submitted to Owner on Trade Payment Breakdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performed early in job:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excavation</td>
<td>$300,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>Foundation</td>
<td>300,000</td>
<td>420,000</td>
</tr>
<tr>
<td>Performed late in job:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interior</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>Landscaping</td>
<td>300,000</td>
<td>270,000</td>
</tr>
<tr>
<td>All other phases</td>
<td>1,800,000</td>
<td>2,160,000</td>
</tr>
<tr>
<td>Overhead &amp; profit add-on @ 20%</td>
<td>3,000,000</td>
<td>600,000</td>
</tr>
</tbody>
</table>

While the $600,000 add-on is twenty percent of total estimated direct cost, it is apparent that more than twenty percent has been added to the cost applicable to the early phases of the job and that no profit or amounts less than cost are reported for phases which will be performed later. For example, the allocated profit for excavation on a ratable basis would be $60,000. However, as that phase of the work is completed, the owner would actually be billed two and one-half times that amount and the contractor would obtain an “interest free loan” of $90,000 for a significant time period during the job.

Another aspect of this technique is to consider areas of the job which may result in change orders or billable quantity overruns. The built-in profit percentage on those phases would be significantly higher than the overall job profit, and such margins could be carried over when negotiating change orders or billable extra units. This approach requires a judicious study of the plans and specifications and is particularly appropriate on jobs bid on a unit-price basis.

Tax Practices

Tax Deferral. Assuming a fifty percent income tax rate, for every $1,000 of profit collected, $500 will be paid in federal and state income taxes. Because the tax rate is so high, tax deferral is an important money-management technique. It involves selecting an income tax method which will defer recognizing profit on long-term contracts.
from the owner. In effect, billings from the subcontractor are ignored, and the quantities allowed by the owner are used as the basis for paying the subcontractor. In this way, the general contractor is paying only the applicable portion of cash received from the owner.

Much of today’s construction involves the purchase and installation of sophisticated and expensive equipment as part of the construction process. The contractor should understand the terms of the contract relating to payment for purchased, but uninstalled, material or equipment. Contractors have incurred significant cash obligations to have equipment available for installation when needed: they have had to make cash purchases early in the job, yet, under the contract, wait for payment following installation near the end of the job. Retainage can represent an unconverted cash asset for a number of years unless a follow-up monitoring system is developed and contact with the owner is scheduled on a periodic basis.

Summary

Cash management for contractors involves not only the day-to-day monitoring of cash balances but also encompasses a wide range of management techniques. It requires a comprehensive understanding of billing techniques as well as the projection and monitoring of cash activities.

Construction is a cash business which can be profitable for the contractor who understands the total business and not merely the estimate, bid and build activity.

Another area often overlooked by contractors in maximizing the cash position is collecting retainage on previously completed jobs. Retainage is frequently withheld pending the completion of several minor "punch list" items related to the construction. An aggressive position must be taken in completing these items. Often, when a job is completed, the project manager is assigned to another job and company management becomes heavily involved with jobs in progress and new bids. Retainage can represent an unconverted cash asset for a number of years unless a follow-up monitoring system is developed and contact with the owner is scheduled on a periodic basis.

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The pair of heat pumps--one for the second floor and one for the first--operate like refrigerators in reverse. In cold weather, they extract heat from the outside air and pump it into the house's hot air ducts. In warm weather, by contrast, the heat pumps can be reversed to provide central air conditioning for the house.

On the few extremely cold, cloudy days, when neither the solar collector nor the heat pumps can supply enough heat, electrical resistance heating is turned on automatically to assist in the heating effort.

According to Dr. James B. Comly, manager of the Thermal Branch at the GE Research and Development Center, "The heating system for the Wenning House was designed to be constructed from off-the-shelf components readily available from GE and other manufacturers."

The GE research manager predicted that the energy saved annually by this special heating system will be roughly equivalent to 1,600 gallons of fuel oil or 31,000 kilowatt hours of electricity.

The installation cost of the heating system was nearly $20,000 greater than that for a conventional heating and air-conditioning system for the same-sized house. However, depending on prices, the savings in fuel and electricity will make up the cost differential in 10 to 25 years, while helping to realize the nation's energy-conservation goals.

Construction of the Wenning House was supported in part by the U.S. Department of Housing and Urban Development, which is providing $15,000 to Solar Structures, Inc., to cover the incremental costs of the solar energy heating system. In addition, the house is equipped with an instrument room with outside access so that the performance of the heating system can be scientifically monitored and evaluated. The finished cost of the house is approximately $150,000.
Although several methods exist, most successful contractors have adopted the completed-contract method for income tax purposes, even though a different method, such as the percentage-of-completion method, is used for financial statement reporting purposes. The contractor who is able to defer the payment of income taxes until the job is completed can use the cash (which will ultimately be paid in taxes) for as long as he defers payment. Most contractors, recognizing that the obligation to pay taxes ultimately must be met, maintain liquid funds for these payments, rather than investing in such non-liquid assets as equipment and real estate.

Maximizing Investment Credits. While most contractors take investment credits for heavy equipment and other readily apparent equipment assets, many contractors overlook other items directly related to a construction project which may qualify for investment credit. For example, assuming a contract with a four-year construction term, certain temporary facilities, such as bridges or breakwaters which will be in place during the term of the contract but which will ultimately be removed and sold off for salvage, may qualify as equipment for investment credit purposes. In a large, long-term contract such assets could generate significant tax savings and maximize cash flow. In addition to temporary facilities, other reusable items, such as concrete forms, steel sheathing and piles, may be considered equipment for investment credit purposes and again could result in significant tax savings. Thus, the contractor should look beyond his heavy equipment and evaluate other job-related equipment for possible additional investment tax credits.

Limited Partnerships. Many successful contractors have been able to further reduce their income tax obligations and maximize available cash by using tax-sheltered limited partnerships for investment in real estate properties. However, the decision to invest should be based on the economic substance of the property and its long-run potential value to the contractor (with the tax sheltering benefit as an added incentive).

Programming Cash Flows

Most successful contractors have recognized the need for meaningful cash-flow projections and have devoted extensive resources to develop such information; they then monitor actual performance against their projections. Various time-sharing services have computer programs available which could be adapted to a contractor’s needs and allow him to project further cash and operating performance. It is important to recognize that cash management requires a plan or program and performance measurement. You can’t manage what you don’t plan.

Avoiding Excessive Investment in Equipment

Many unsuccessful contractors have filed for bankruptcy because they have become “equipment poor.” Usually such companies have obtained one contract requiring purchases of specific types of equipment that, unfortunately, they have never again needed. This can result in heavy cash drains because the purchased or leased equipment remains idle for extended periods of time. The successful contractor, as part of his planning process, carefully determines his area of construction concentration and his equipment needs on a continuing basis. He then buys only what is absolutely needed. Additional equipment is rented on a job-by-job basis to avoid excessive investment in equipment which may ultimately be unproductive.

Subcontractor Payment Clauses

In dealing with subcontractors, successful general contractors have followed the philosophy of including in written subcontract agreements, clauses which require that payments to the “sub” be made only as payments for related work performed are received.

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