TOP 15
Accounting Habits of Successful Contractors

By Bob Teska

A three-part NASBP *Surety Bond Quarterly* magazine article for NASBP bond producers and their construction clients.
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Top 15 Accounting Habits of Successful Contractors

Part 1 of 3

BY BOB TESKA

WHO DOESN'T LOVE a list of the "Top" things to do? Topics like the "Top 15 Vacation Getaways for under $1,000" or the "Top 15 Road Trips Around America" garner a lot of excitement. So, it would stand to reason that a list about the "Top 15 Accounting Habits of Successful Contractors" would evoke a palpable state of euphoria, right? Perhaps I am overstating the hype that this article will produce. The fact is that accounting is often an afterthought for many contractors. However, successful contractors understand that good accounting is the language that translates the excellence they create in the field into a language that stakeholders such as bankers, insurance agents, and bond producers as well as sureties use to support their operations. In Part 1 of this series, we are going to look at the first five accounting habits of successful contractors.

1. Hire a Highly Qualified, Construction-Focused CPA

Successful contractors hire highly qualified, construction-focused certified public accountants (CPAs). Just like contractors, CPAs have specialties. Contractor financial statements present unique information, such as a work-in-process (WIP) schedule, and contain required disclosures that are specific to the construction industry. Presenting this information properly gives sureties confidence in the financial statements they are using to make underwriting decisions. In addition, the Tax Code has specific provisions, many of

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them favorable, for contractors. Contractors should hire a CPA who understands the nuances of construction accounting and taxation. If possible, contractors should hire a CPA that also holds the designation of Certified Construction Industry Financial Professional (CCIFP). The expertise of these construction CPAs will probably cost more than the average CPA, but successful contractors understand that the quality of financial statements, expert tax advice, and industry-specific consulting will more than pay for itself.

2. Hire a CFO or Controller Who Understands Construction Accounting

Next, successful contractors hire a chief financial officer (CFO) or controller who understands construction accounting. Again, this generally is not going to be the cheapest option; but the dividends of hiring a highly qualified CFO are substantial. First, a highly qualified CFO will understand the language of construction and be able to converse seamlessly with project managers and subcontractors. This will help with the smooth administration of projects. Next, they will be able to provide outside CPAs with information in the format they need, which should save the CPA time and reduce the contractor's bill from the CPA. A CFO with construction experience will be able to help a construction owner understand all of the financial information. There are several ways to find a good CFO. The easiest way would be to have the time and foresight to hire a staff accountant, let him or her work and train under an existing quality CFO, and then promote the staff accountant when the time is right. If you don't have the luxury of time, another option would be to advertise the job opening and ask your CPA to help you interview candidates so the CPA can determine the candidate's understanding of construction accounting. Lastly, contractors frequently hire a CFO from the ranks of the CPA firm that does their year-end audit and tax work.

3. Use the WIP Schedule as a Tool to Manage Jobs

Another accounting habit of successful contractors is that they use their WIP schedule as a tool to help them manage jobs. Too often, contractors only produce a WIP schedule when the surety requests it for a bid or at year end for the CPA. However, a successful contractor that has a high-quality CFO will look at it monthly to identify jobs with issues, problem project managers, and cost overruns. Being able to produce timely, accurate WIP schedules is always appreciated by the surety team and the CPA.

4. Monitor Aging Accounts Closely

The best-in-class contractors monitor their aging accounts receivable like a hawk. Successful contractors will pass up on work if they know the owner or general contractor (GC) on a project has a history of slow paying or not paying. It has been my observation that, when it comes to accounts receivable (AR) collections, the "squeaky wheel gets the grease." Often successful contractors will have an escalation in response to receivables as they age. For example, at 60 days the project manager will call the owner/GC; and at 90 days the construction company owner will call; and at 120 days it might get turned over to legal. Depending on the type of contract and the owner, that particular escalation may need to be adjusted. The key is to not let AR get old without following up.

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5. Negotiate a Reduction in Held Retainage After Milestones Are Met

Related to number four, above, is retainage collection. It is possible that most or all of the gross profit on a project could be held in retention. That makes collecting retainage a crucial accounting step. Successful contractors negotiate a reduction in held retainage after certain milestones are met. A good CFO will track this and make sure the billings reflect the reduction in retainage. Obviously, completing the project and punch list items is a must (and outside of accounting). However, it is important to communicate with the CFO so the CFO knows when retainage can be final billed. Then a follow-up escalation process, similar to what was described in accounts receivable, should be followed until collection of retainage is received.

While this list may not be as exciting as the best vacation spots, following these steps can help save for a lot of vacations! Part 2 of this series will look at how successful contractors address billings and accounts payable.

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Find Out More

Read Teska's *SBQ* article that highlights how "slow and steady" progress can help contractors succeed: https://bit.ly/46CR7TQ.
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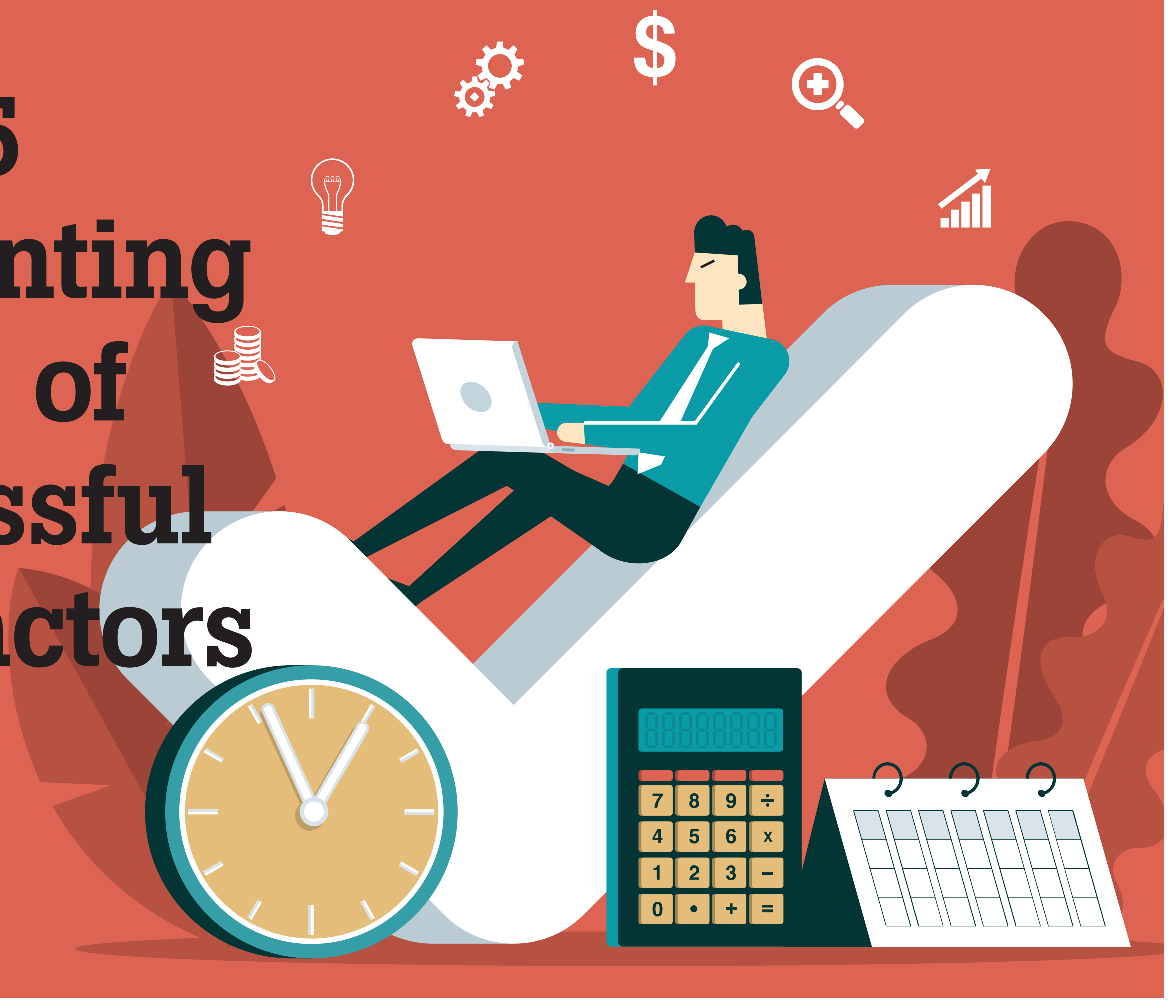
Part 2 of 3



IN THIS THREE-PART series I endeavor to explain the "Top 15 Accounting Habits of Successful Contractors." Part 1 focused on hiring the right people, using your WIP schedule as a management tool, and managing cash inflows. Part 2 focuses on managing your cash outflows and minimizing interest expenses.

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6. Properly Time Accounts Payable Payments

The statement "Cash is King" is true for any company, but it is exponentially true for a contractor. This truth is exacerbated if you are a second- or third-tier subcontractor. The farther down the payment stream a contractor is, the more important cash management becomes. In a perfect world, receivables would be collected, and all payables would be satisfied in 30 days. That is not the case most of the time, and successful contractors use accounts payables to help manage cashflow. Generally, a contractor will have some vendors and subcontractors that need to be paid in 30 days. After those are paid, a successful contractor will match payments made to when receivables are collected. This helps keep the contractor from becoming a bank for the project owner and incurring interest costs from bank line of credit usage. Another key step is to not pay retainage payable until retainage receivable is collected. This continues to match cash collections with cash outflows and helps keep the contractor cashflow positive.

7. Monitor Loan Covenants

Often when a contractor obtains a bank loan for equipment or property purchases, the lending bank will require the contractor to maintain certain financial metrics during the life of the loan. These metrics are commonly referred to as loan covenants. Common loan covenants include:

- Maintain a minimum debt service coverage ratio (DSCR). A common threshold for the DSCR is 1.2. The DSCR assesses an entity's ability to service (repay) its debt. It is calculated by dividing the net operating income by the total debt service (principal and interest payments) for a given period. A high DSCR indicates a greater ability to meet debt obligations. A DSCR less than one suggests that an entity may struggle to meet its debt obligations.

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- Maintain a debt-to-equity ratio (DTE) below a certain threshold. DTE compares a company's total liabilities to its equity and measures a company's reliance on debt in its capital structure. It is calculated by dividing total debt by total equity. A very high DTE ratio may signal potential solvency issues, while a low ratio suggests a reliance on equity in the capital structure to fund growth. The DTE ratio required by the bank will be very dependent on the type of contractor that obtained a loan. A heavy highway contractor, who is heavily dependent on equipment, may be allowed to go up to a DTE of 2.0 while an electrical contractor, who generally has much less in capital expenditures, may only be allowed a DTE of 1.2.
- There could also be requirements on minimum cash balances, minimum equity required to be left in the company, or limitations on distributions paid during the year.

The bank may want to review the covenant calculations on a quarterly or annual basis. If a contractor fails a bank covenant, the bank has the right to call the loan or issue a waiver. When a waiver is issued by the bank, a fee is generally required to be paid by the contractor for the waiver. The fee can be substantial depending on the size of the loan. A successful contractor has a CFO that regularly monitors the bank covenants and evaluates any potential transactions the contractor wants to make against the effect on the bank covenants. The CFO can then provide guidance on how to structure the transaction in a way to ensure the covenant does not fail. If failing a bank covenant is unavoidable, a successful contractor will communicate with the bank well ahead of time, explain the reason for failing the covenant and how he or she plans to get back on track, and proactively negotiate any fee associated with a waiver being issued. Up-front communication with the bank is always better, and typically viewed as more favorable, than just surprising the bank with a failed covenant.

8. Negotiate Better Interest Rates

Successful contractors never pay more in interest than they have to. This starts with the company and the company owner(s) having good credit scores. Having a good credit history will give the contractor options when obtaining new financing. When obtaining significant new financing, a successful contractor will send out a request for proposal (RFP) to multiple banks. I recommend reaching out to three to five banks. After all banks have responded, a good practice is to meet with each bank and negotiate the terms of the loan against each bank. The competition created by using a process like this will allow our "free market society" to provide the most favorable terms for new financing. Successful contractors also monitor the interest rate environment, and, as rates drop, they will renegotiate existing debt that has higher interest rates to more favorable terms.

9. Cashflow Projections

Another tool used by successful contractors are cashflow projections. This is an advanced technique that can be time consuming to set up but relatively easy to maintain. However, with the understanding that "Cash is King," the time spent on this process reaps significant benefits. The most useful way to project cashflow for a contractor is to do it on a project-by-project basis, for a rolling 12-to-24-week period of time. The process involves projecting cash receipts and disbursements by project that roll up into a full company cashflow projection. This allows the contractor to project weeks in advance when cash may get low and necessitate advances from the line of credit. It also helps plan for when larger discretionary expenditures like owner distributions or employee bonuses can be made without putting a strain on working capital.

10. Capital Expenditure Budget

Lastly, a successful contractor prepares and uses a capital expenditure budget (CEB). A CEB is a budget for large equipment purchases. Generally, the accounting department will work with the company owner or fleet manager to determine when current equipment will need to be replaced based on age, usage, and current job requirements. Having a plan for systematic replacement avoids excessive maintenance costs and the sudden, unplanned need for cash to replace a piece of equipment. In addition, understanding what jobs are in the backlog will provide insight into the need for additional equipment purchases. If there is a short-term need, a rented piece of equipment may be a good option. However, rental fees can accumulate quickly so a rental agreement that contains a purchase option is always a good negotiating point.

Managing cash outflows may seem like running a zone defense in basketball. It's not flashy, and it won't impress the crowd, but if it is properly executed, it will shut down the opposing offense and win the game. If you want to be successful in construction, proper cash management has to be part of your game plan. View part 1 here https://www.suretybond quarterly-digital.com/sbpq/0324_fall_2024/MobilePagedArticle.action? articleI d=2011168#articleId2011168. ●

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Part 3 of 3

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IN PARTS 1 and 2 of this series I covered 10 accounting habits of successful contractors that, if employed, will set the contractor apart from its peers. The company can be one that banks want to lend to and that bond producers and sureties will want to work with. In the final part of this three-part series, I am going to share five additional accounting habits which I believe are employed by "ultra successful" contractors.

11. Treasury Management

In part two of the series we talked about how "cash was king." The ultra successful contractor goes beyond knowing that cash is king and develops a Treasury Management strategy. Treasury Management is the process of managing a company's finances, including cash flow, investments, credit lines, and risk management. Another way to think about it is to answer the question, "How do we maximize the benefit of the cash we have collected?" This is a very deep topic to which we could devote another article series. We will scratch the surface with the two examples below:

- Excess funds are invested. Generally, cash sitting in a traditional bank account will not earn much, if any, interest. Successful contractors will invest cash in excess of their working capital needs into short-term

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investments. These are not the funds a contractor would want to invest in highly speculative or risky investments. The key here is to pick relatively safe investments that can be turned back into cash quickly if there were increased working capital needs. I would suggest working with a trusted investment advisor to design a portfolio that meets their goals and risk tolerances. To borrow a baseball analogy, you are looking to hit a single here, not a home run and you definitely don't want to strike out. One other comment would be that it is best to discuss your investment strategy with your bond producer and surety, so you don't inadvertently affect your bonding capacity due to your investment choices.

- Set up an automatic sweep account. A sweep facility automatically moves cash from one account to another account when the balance reaches a predetermined limit in the first account. It could be swept to a line of credit account, which would reduce outstanding principal and save interest, or it could be moved to an interest-bearing account where the excess cash would earn interest. There are costs associated with using a sweep facility, so an analysis needs to be done to ensure that the interest expense saved or interest income earned is greater than the cost associated with the sweep facility.

12. Use Positive Pay

Positive Pay is a fraud prevention tool offered by most banks. The contractor's accounts payable department provides the bank with a list of checks that it has issued, including information like the check number, check amount, and what account the check was drawn upon. When the payee presents the check for payment, the bank compares the information on the check against the list provided by the accounts payable department. If there are any discrepancies, the bank alerts the company and withholds payment until the differences can be reconciled. Positive Pay protects against fraudsters obtaining a check written to a legitimate vendor, changing the payee and possibly the amount to be payable to the fraudster, and then, absconding with the funds by cashing the check. A contractor should not think, "this will never happen to me." This type of fraud occurs far too often. The Positive Pay process takes a little extra time, but with the reports of increased fraudulent activity, it makes sense to spend the time to protect the cash you have earned.

13. Strong Controls Around Wire Transfers

Unfortunately, in the day and age we are living in, fraud is an everyday occurrence. Wire fraud is one of the most common and often highest-dollar fraud that occurs. It is not hard for a fraudster to pose as a vendor and convince busy accounts payable employees to send a seven-figure subcontractor payment to them instead of to the intended subcontractor. Ultra successful contractors have developed a strong, internal control process around wire transfers. When it comes to wire transfers, education is the key. Consistent training to help employees identify potential scams and notify management of suspicious requests will stop any fraud before it can occur. In addition, always verify the authenticity of each wire transfer request by implementing a two-step verification process. Call the vendor, using a number previously used and not provided in an email request for payment, to verbally verify the actual request and the account number. The contractor should also implement dual controls—two employee authorization and segregation of duties, where one person receives the request for funds and a second person authorizes the release of funds. The above are just a few examples of controls. I strongly recommend a contractor works with its lending institution and construction CPA to develop strong internal controls around wire transfers to help prevent fraudulent payments.

14. The CFO Says NO! (and the Contractor Listens)

We have already discussed that successful contractors hire high-quality, construction-specific CFOs. Ultra successful contractors listen to their CFO when they say "no." One example would be when the contractor wants to take a large discretionary distribution. If the CFO knows that the reduction of cash would have a negative effect on the working capital needs of the company because they are in a growth phase, the CFO should advise against the distribution at the current moment. The "I earned the money, and you can't stop me" contractor will take the distribution and let the company suffer the working capital pinch, which could impede the company's future growth. The ultra successful contractor trusts the professionals it employs and dials back the amount required for a distribution or delays the distribution until working capital requirements have evened out.

15. Update Meetings with Bond Producer and Surety Underwriter

Many contractors avoid meetings with their surety team. They think the bond producer and surety are just looking for reasons to say "no." The contractor employs a strategy of telling the surety team as little as possible and hiding as much as possible and then gets upset when bonds become hard to obtain. In contrast, an ultra successful contractor sees its bond producer and surety underwriter as part of its circle of trusted advisors. Ultra successful contractors have open conversations with the surety team and discuss major decisions or events with them BEFORE they occur. One example would be where the contractor was selling part or all

…AN ULTRA SUCCESSFUL CONTRACTOR SEES ITS BOND PRODUCER AND SURETY UNDERWRITER AS PART OF ITS CIRCLE OF TRUSTED ADVISORS.

of their interest in the company to a son or daughter. Too often the surety finds out about this when the year-end financial statements are issued by the CPA. At this juncture the surety has to react, and the reaction could be severe. However, an ultra successful contractor brings the bond producer and surety into the conversation at the planning phase of the transition, so they can work with the contractor to develop a transition strategy that provides no disruption to the bonding program. In my opinion, open communication and dialogue with the surety team wins the day.

The accounting habits employed by successful contractors are . . . well . . . kind of boring. They are tried and true methods. None of them individually are eye-popping, and none of them individually will make you successful. Just like one brick doesn't make a building. You need to lay one brick down, add mortar, then another brick and repeat until you reach the top. That is how the accounting habits of successful contractors work. Employ one, then another, and with some diligence and time you will be a successful contractor.

Read the first two parts of this article: Part 1, https://www.suretybondquarterly-digital.com/sbpq/0324_fall_2024/MobilePagedArticle.action?articleId=2011168#articleId2011168; Part 2, https://www.suretybondquarterly-digital.com/sbpq/0424_winter_2024/MobilePagedArticle.action?articleId=2027774#articleId2027774.

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