



CONSTRUCTION INDUSTRY ADVISOR

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Cash flow strategies for construction companies

Cash flow is the lifeblood of every business, but it's especially vital for construction companies. In an industry characterized by razor-thin profit margins, solid cash management practices can make the difference between success and failure.

And healthy cash flow is even more important today in light of the Federal Reserve's recent interest rate hikes. As of this writing, interest rates have reached their highest levels in more than 15 years — substantially increasing borrowing costs. Suppose, for example, that a construction company has drawn \$1.5 million on its line of credit. If the interest rate rises from 3% to 8%, the business would see its annual interest expense increase by \$75,000.

So, while credit lines remain a valuable tool for weathering financial shortfalls, your construction company should still take steps to improve cash flow and minimize dependence on bank credit. Here are some strategies to consider.

Prepare forecasts

Regularly forecasting cash flow can help you identify potential drains and anticipate problems before they get out of hand. Doing so also enables you to better understand the impact of various activities and practices on cash flow, again allowing you time to make needed adjustments while there's still time to turn things around.

In addition, forecasting helps you match cash inflows to outflows to the extent possible. For instance, you may be able to negotiate payment terms with

your vendors that are designed to coincide closely with receipts from customers.

Front-load billings

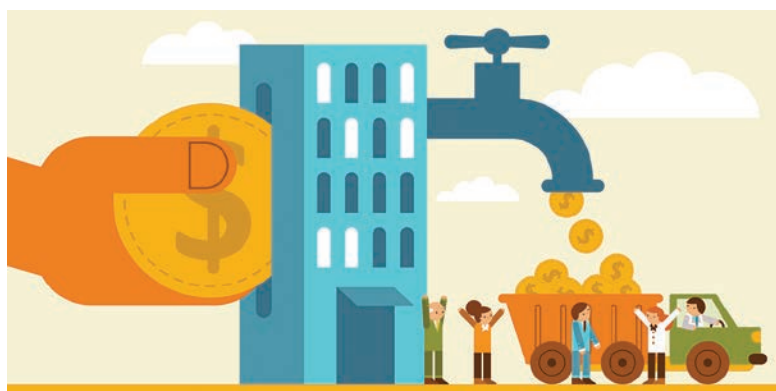
Construction contracts often call for progress payments from project owners as specified milestones are reached or as certain phases are completed. Unfortunately, these payment schedules rarely correspond to the contractor's job-related cash needs.

As you're no doubt aware, projects typically involve substantial upfront costs for mobilization, labor and supplies. So, if possible, negotiate a front-loaded billing schedule that recognizes your greater need for cash at the beginning of a job.

Eliminate or reduce retainage

Many construction contracts allow the project owner to retain a certain percentage of the total price (usually 5% to 10%) until work has been completed. Because retainage can have a big impact on cash flow, try to negotiate a lower percentage or ask the owner to phase out retainage over the course of the project.

For example, the contract might call for 10% retainage but release half of that amount to you when the



Are you using the right tax accounting method?

Taxes can have a big impact on cash flow, so it's important for construction businesses to regularly reevaluate their tax accounting methods. In some cases, changing accounting methods may provide an opportunity to defer taxes — thereby improving cash flow.

Changes made by the Tax Cuts and Jobs Act of 2017 allow construction companies with average gross receipts of \$29 million or less (as indexed for inflation for 2023), as well as certain other businesses with higher gross receipts, to use the cash method of accounting for tax purposes. Eligible companies that are currently using the accrual method may be able to defer taxes by switching to the cash method.

These same businesses may also qualify to use the completed contract method rather than the percentage-of-completion method to account for jobs expected to be completed within two years. Under the completed contract method, income generally isn't reported until the contract is substantially complete. Consult your CPA on whether your construction company would benefit from a change in accounting methods.

job is 50% complete and the remainder when the project reaches 75% completion. In some cases, you may be able to eliminate retainage entirely by providing the owner with other forms of security, such as a letter of credit or performance bond.

Stay on top of receivables

Make sure payment terms are clearly spelled out in your contracts. Have policies, systems and procedures in place to ensure that your construction company issues timely invoices. Reinforce with owners that payments are expected on a scheduled basis — don't wait until a payment is past due to remind them.

Consider offering discounts for early payments if it makes sense from a cash flow perspective. To help owners pay promptly or even early, offer a variety of payment methods. If you haven't already, explore the feasibility of today's popular payment apps such as Zelle, PayPal and Venmo.

Work with vendors and suppliers

Vendors and suppliers may offer discounts or more favorable payment terms in exchange for bulk purchases or cash payments. Of course, keep in mind that ordering too much of certain items can consume available cash and increase storage costs.

Also, by coordinating with vendors, you may be able to spread out payables by arranging staggered payment dates. Don't pay vendors earlier than required unless you'll receive a discount for doing so.

Manage change orders

Change orders are a fact of life in the construction business. However, if you don't manage them properly, you'll risk delayed payment for the additional work — or you may not get paid at all.

Be sure that your contracts establish clear terms and procedures for approval and payment of change orders, and that your employees understand and follow those procedures. To avoid cash flow disruptions, it's critical to submit the necessary documentation and bill for change orders in a timely and accurate manner.

Think continuous improvement

Although profitability is the ultimate goal of every business, healthy cash flow is just as important. Even a construction company that's highly profitable on paper can fail if it lacks the cash it needs to complete current projects and competitively bid on new ones. Your CPA can help you track your cash flow and identify optimal ways to continuously improve it. ■

Joint ventures offer both revenue and risk

Some construction projects are too big or too complex for one general contractor alone. In such instances, a viable solution may be for two construction businesses to form a joint venture. This is a legal agreement between the two entities to collaborate on the job, sharing both the revenue and the risks.

If your construction company encounters an opportunity to participate in a joint venture, proceed carefully. It may indeed be a chance to work on a large, high-profile project that boosts your reputation and elevates your revenue projection for the year. It may also represent a good way to enter a new market, as well as gain experience and expertise through collaboration. But those risks we mentioned — you've got to be prepared for them.

Reasons to participate

Contractors choose to participate in joint ventures for various reasons. Some projects, though potentially lucrative, are beyond the financial capabilities — in terms of both

bonding and working capital — of a single construction company. A joint venture can reduce the amount of each participant's investment to a manageable level.

There's also a risk management benefit. A joint venture provides an opportunity for two or more contractors to participate in larger or more complicated projects than they usually would. The financial and other risks of such jobs are shared by participants so, if things go awry, one business won't have to absorb all the negative repercussions.

A construction company might be able to broaden its horizons through a joint venture — literally. Contractors can move into other geographic markets by forming joint ventures with construction businesses in those areas.

Joint ventures sometimes play a role in diversity initiatives, too. It's not unusual for bigger construction businesses to partner with smaller, minority-owned companies to enhance diversity and bolster the reputation of the industry.



Difficulties to anticipate

The primary disadvantage faced by participants in a joint venture is loss of control. Most contractors are accustomed to managing project operations without input from another leadership team. However, when you become a partner in a joint venture, you must consider the interests of the other party and sometimes change how you do things.

In fact, important decisions on joint ventures are typically the result of compromise, after much discussion, between the partners. By the same

token, an unwillingness to compromise is a major reason why some joint ventures fail — and the consequences of failure can be steep. You may not only lose the anticipated revenue, but also get yourself into a prolonged and expensive legal battle. Your construction company's reputation could suffer as well.

An agreement's nuts and bolts

To prevent disaster, the parties involved should draft and sign a comprehensive joint venture agreement. The specific provisions of such an agreement may differ depending on the project and participants. However, commonly addressed items include a statement of the venture's purpose and provisions addressing the capital contributions to be made by each participant (such as cash, equipment and other project elements).

The agreement should also state the rights and responsibilities of each participant — including bonding obligations if those apply. It needs to

include stipulations regarding matters such as how profits and losses will be shared, as well as how major decisions will be made. In addition, the agreement should anticipate negative developments. What, if any, dispute resolution measures will be used? Under what circumstances can the joint venture be terminated?

Be sure any prospective joint venture allows time for you to have your attorney review the agreement, as well as for some negotiation between you and the other party.

Opportunities ahead

One recent development that may boost the prevalence of joint ventures is foreign construction businesses pursuing partnerships with U.S.-based companies to complete federally funded infrastructure projects. It's perhaps something to keep an eye on if such jobs pop up in your market. Contact your CPA for help evaluating whether to participate in any joint venture. ■

Tired of HR hassles? Consider a PEO

For small to midsize construction businesses, recruiting and retaining employees is a challenge. There's not only a shortage of qualified workers, but also the inflation-driven rise in the costs of providing an attractive benefits package. Plus, dealing with issues related to human resources (HR) can distract management from its core business activities. One potential solution is to use a professional employer organization (PEO).

How does it work?

A PEO is an HR outsourcing provider with which your company forms a "co-employment" relationship. Your business retains control over hiring and firing decisions, as well as day-to-day employee performance management. Meanwhile, the PEO

acts as the employer for purposes of most HR and benefits administration functions. Working with a PEO in this manner typically offers a variety of advantages, including:

Better employee benefits. Because PEOs pool their clients' employees, they typically have access to high-quality health care and retirement plans, as well as other benefits, that would probably be too expensive or difficult to administer for a smaller company.

Assistance with payroll and tax administration. A PEO can relieve your business of many of the burdens associated with payroll processing — including tracking hours, withholding and remitting taxes, and distributing checks.

Reduced workers' compensation costs. When you partner with a PEO, your employees are covered by its master workers' comp policy. Premiums are based on the PEO's experience modifier rate, which can translate into substantial savings for your construction company. The PEO can also save you time and money by handling all claims.

HR expertise. Many PEOs provide end-to-end HR services, helping you search for talent and recruit employees, and even handling onboarding and training.

Compliance assistance. PEOs typically have the expertise to help your company comply with various federal and state laws related to retirement plans, health care plans and protected information, and safety. They can also handle unemployment claims. Some PEOs even provide safety audits and training programs.

What are the risks?

As with any outsourcing arrangement, the biggest risk involved in using a PEO is that you relinquish control over certain activities while remaining liable for any related compliance issues.

One area where you may be able to shift liability to a PEO is tax compliance. Ordinarily, a firm's "responsible persons" — including certain owners, officers and employees — are personally liable for any failure to collect and remit payroll taxes, even if that responsibility has been delegated to others.



There's an exception, however, for PEOs that have been certified by the IRS. These certified PEOs are solely responsible for their clients' payroll tax obligations, allowing those clients to avoid liability for payroll tax compliance issues.

Additional note: Because job costing must be done at the company level, many construction businesses may have to do their own payroll. This could limit the practicality of a PEO arrangement.

Is it the right move?

A good PEO can give a small to midsize construction company a competitive advantage in having top-notch benefits and HR services. But, as noted, there are risks and substantial costs to consider. It's critical to thoroughly vet the reputation, references and financial condition of any potential partner. If interested, discuss the idea with your leadership team and professional advisors. ■

Contractors: Watch out for occupational fraud

Nearly every type of business could be affected by occupational fraud, and construction businesses are certainly no exception. In fact, the Association of Certified Fraud Examiners (ACFE) reports that construction

is among the industries with the highest median fraud losses.

According to the ACFE's most recent fraud survey — *Occupational Fraud 2022: A Report to*

the Nations — construction ranked fourth, with a median loss of \$203,000. Only real estate, wholesale trade, and transportation and warehousing had higher median losses. Construction also had the second highest average loss at \$2,868,000.

Knowing where to look

Obviously, it's tough to stop fraud unless you know where to look. According to the ACFE report, the most common occupational fraud schemes in the construction industry were:

- Corruption, such as bribery or conflicts of interest (56% of cases),
- Billing schemes, where an employee submits invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases (24% of cases),
- Noncash misappropriation, where an employee steals or misuses noncash assets, such as inventory, equipment or confidential customer information (24% of cases), and
- Payroll schemes, where an employee makes false claims for compensation; for example, by claiming overtime for hours not worked or adding ghost employees to the payroll (24% of cases).

As you peruse that list, think about whether and how those crimes could strike your construction company. Do you believe you have adequate anti-fraud measures in place, or are there parts of your business vulnerable to wrongdoing?

Staying in control

To prevent fraud, it's critical to have a strong

system of internal controls. Common examples of these include background checks, segregation of duties, dual authorization of sizable payments and management review of major processes. Per the ACFE report, nearly half of reported fraud cases occurred because of lack of internal controls (29%) or override of existing controls (20%). Another 16% were attributable to lack of management review.

In addition, the ACFE's survey found that several antifraud controls are particularly effective in detecting fraud early and minimizing losses. They include fraud hotlines (the most common way frauds are detected), job rotation/mandatory vacations, surprise audits, proactive data monitoring/analysis, antifraud policies, formal fraud risk assessments, fraud training, codes of conduct, and dedicated fraud departments or functions.

Minimizing your risk

Your construction company's exposure to occupational fraud risks depends on its distinctive facts and circumstances. A good way to start fortifying your defenses is to conduct a formal risk assessment to pinpoint the areas where your business is most vulnerable. Don't hesitate to ask your professional advisors, including your CPA, for help. ■





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The **LaPorte Construction Industry Group** has worked with construction clients for over half a century. We understand the special audit, tax, and consulting needs of construction-related businesses.

Our professionals — including four certified construction industry financial professionals (CCIFPs) — work hard to raise the bar on serving their clients and on educating themselves, resulting in tangible benefits for our clients. Also, our professionals attend annual construction conferences, giving us a broader industry perspective on our clients' operations and making us more able to offer technical proficiency and bring valuable ideas to the table.

Commitment to the Construction Industry

Our professionals actively participate in the following trade organizations and associations, often in leadership roles:

- American Subcontractors Association
- Associated Builders & Contractors
- Associated General Contractors
- Commercial Real Estate Women
- Construction Financial Management Association
- Construction Industry CPAs/Consultants Association
- Surety associations in Louisiana and Texas

Construction Client Base

- General contractors
- Heavy and highway contractors
- Marine and shipbuilding contractors
- Oilfield services contractors
- Pipeline contractors
- Real estate developers
- Residential and nonresidential builders
- Specialty trade contractors

Services to the Construction Industry

Compliance

- Attest and assurance
- Tax return preparation

Tax Consulting

- Business valuations
- Cost segregation studies
- Equipment buy vs. lease decision analyses
- Executive compensation reviews and evaluations
- Family business succession planning
- Guidance on payroll tax and independent contractor issues
- Guidance on sales and use tax issues for contractors
- Identification of available federal and state credits
- Multi-state income and franchise tax planning
- Planning for application of advantageous long-term contract tax accounting methods

Other Consulting

- Benchmarking analyses
- Internal control studies and evaluations
- IT risk and controls assessments
- Payroll and benefits services
- Performance/operational reviews
- Software training support
- State contractors licensing applications
- Technical accounting support, including assistance with implementing new accounting pronouncements

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