

CLEAN UP YOUR BOOKS FOR YEAR-END MEETINGS WITH SURETIES, LENDERS

White paper by:

Chris E. Hartle, CPA

Senior Manager, Construction Team

Barnes Dennig



CLEAN UP YOUR BOOKS FOR YEAR-END MEETINGS WITH SURETIES, LENDERS

With 2008 hard on the horizon, it's time for construction company owners to organize their financial statements and schedule a year-end meeting with sureties, bankers and other financial partners. This meeting can be crucial, because underwriters need to see evidence of sound business practices before providing financial support for another year.

Before meeting with your bonding agent and banking partner, take the following steps to improve your financial picture.

1. Make sure your financial statements reflect a continuous effort to improve working capital.

For example, if your company's line of credit was increased during the year because you reduced debt in a timely fashion, highlight that fact.

Working capital gauges a firm's ability to finance its operations and indicates the level of protection creditors and surety companies can expect when they underwrite operations. It also indicates how well a construction company can fund its volume of work. To determine whether there is adequate working capital, sureties and bankers calculate the company's Current Ratio. Derive this ratio by dividing current assets by current liabilities. For example, if a contractor has current assets of \$400,000 and current liabilities of \$250,000, the Current Ratio is 1.6 to 1.

In general, sureties and lenders hope to see current ratio of 2 to 1 or even 2.5 to 1. However, a contracting company can have a ratio of 1.25 to 1 and still be in good financial shape, depending on its size and the type of work it most often conducts.

2. Bolster net worth.

Sureties in particular pay close attention to net worth because it tells them how much loss a contractor can absorb. Bonding agents and bankers want to see that company owners are retaining earnings and not paying out a disproportionate amount to shareholders. They also don't want to see a company buying real estate unless it is for business purposes and is being rented back to the company.

A key component of overall net worth is money on hand. The construction environment varies from year to year, with a good year often followed by a bad year, and so on. Consequently, lenders want to see that contractors have built up enough reserve funds to handle anticipated and unanticipated expenses over the next 12 months. Two ways to increase that reserve fund are:

- Reduce payroll bonuses to owners. Because many construction companies are formed as S corporations, large year-end bonuses do not reduce the amount of personal income tax paid, and in some cases can even increase certain kinds of taxes (such as Medicare tax and local earned income taxes). By reducing bonuses, distributions can then be made from the S Corporation to the shareholders after year end to fund the payment of their tax obligations. By doing this, the corporation will show increased profits and cash at year end. In addition, sureties and banks may frown on stripping out all corporate profits through bonuses, especially if the company isn't sufficiently capitalized.
- Reduce debt and raise cash. One way to accomplish this is by selling appreciated equipment. Contractors who are on thin ice with their surety and bank may consider whether it is more advantageous to lease equipment instead of own. Before the next meeting with underwriters, evaluate your use of equipment and determine whether some of it should be sold to pay down outstanding debt.

Owners also need to consider the cost of their physical plant. As property taxes and insurance costs rise, it may be better for some owners to consider moving their headquarters to enterprise zones that offer various tax advantages. Any tax savings bolster overall net worth, and whether the company shareholders own the real estate or not, there can be significant benefits to being located in an enterprise zone.

3. Manage cash flow.

In a highly cash-intensive business, consistent cash flow helps minimize debt and keep work on schedule.

Cash flow from operations is the cash a company generates from receipts from customers, after disbursements for job costs and overhead, but before asset purchases and debt repayment. Financially sound companies tend to have a ratio of net income (excluding depreciation) to cash flows from operations that is close to 1 to 1 over a five-year period. Companies that aren't faring well tend to have a high ratio of net income to cash flows from operations.

To successfully manage cash flow:

- Research the market and purchase software systems that calculate actual cash flow on a dependable, month-by-month basis. If you can't find specific software, this task can be accomplished through spreadsheet software.
- Don't become complacent about collecting money. At the most successful companies, receivables average fewer than 40 days old.
- Talk with your banker about cash management services.

4. Watch your overbillings and underbillings.

Financial underwriters want to see that a construction company is billing (and being paid) for services in a manner consistent with a project's completion schedule. This is most closely aligned to the percentage-of-completion method for recognizing income. If a construction company has been awarded a \$1 million job that has expenses of \$800,000, when the project is 40 percent complete, the company should have billed out \$400,000. This is important if year-end balance sheets are going to create a favorable picture for sureties and lenders, not to mention the negative effect that delinquent billing can have on cash flow and operations.

Underwriters get nervous when a construction company is overbilling or underbilling. Underbilling in particular raises a red flag, because it can indicate a problem or unprofitable job or poor management practices. Underbillings that reach 25 percent of working capital are particularly troubling for sureties. The most important step a contractor can take before the end of the year is to send out all invoices that can be billed and pursue payment by year end. This will improve the liquidity that bonding companies and banks want to see on the year-end financial statements, as well as reduce any current underbillings on the balance sheet.

5. Accurately account for profit.

Surety companies and lenders want to see evidence that a construction company operates at a steady rate and with accurate work-in-process estimates. For these estimates to mean anything, they must include both an accurate jobs-in-process schedule and a completed-contracts schedule.

Essentially, sureties and bankers want to know if a construction company's books accurately reflect any profit fade. Before meeting with bonding agents and lenders, determine whether carry-over expenses from previous years have created unexpected profit fade. A review of the additional costs and the

construction contract may reveal opportunities to bill for the additional work. If such fade did occur, financial statements need to be updated quickly, and contractors should have a detailed strategy for avoiding profit fade going forward.

6. Address management and employee turnover.

Due to small margins in the construction industry, losing valued workers can wreak havoc not only on operations, but on your financial position as well. One study showed that a construction company can save 2.5 percent of its payroll costs by reducing turnover by 10 percent. If a contractor has a profit margin of only 5 percent, that is an impressive savings.

Bonding agents and lenders want to see a construction company that retains its top managers and valued employees, and they also want to know how long top managers have been with the company and how profitable the company has been under their direction. If you lost top managers this year, discuss the problem openly with bonding agents and lenders so they thoroughly understand why the managers left. If the employees are leaving primarily because of inadequate compensation, discuss the issue with an accountant specializing in the construction industry. With help from such an advisor, you might find a way to raise pay, offer bonuses, create stock option plans or employ other means of making employees feel more like stakeholders and create incentives for them to stick around for the long haul.

One final comment for those planning end-of-year meetings with bonding agents and bankers: Before such a meeting can take place, financial statements need to be reviewed, if not audited, by a CPA. If you act quickly, there is still time to have a CPA review profit-and-loss statements and other reports, and help you prepare for year end.

ABOUT BARNES DENNIG

The mission of Barnes Dennig is empowering individuals and organizations to achieve financial success. With this in mind, Barnes Dennig offers a complete array of accounting services for closely held businesses and individuals including financial reporting, audit, review and corporate and personal tax planning services, as well as business advisory services. In addition, the firm possesses special expertise with closely held manufacturers, wholesaler-distributors, real estate and construction companies and non-profit organizations throughout the region.

Barnes Dennig was founded in 1965 and counts 47 CPAs among its professional staff of 85. The firm's 100 employees are headquartered in the Carew Tower. Ranked as this area's fifth largest CPA firm by the *Business Courier*, the firm has built a solid legacy in the greater Cincinnati region, which results from over 42 years of building success stories for closely held/family owned, middle-market businesses. Clients benefit from the continuity of interacting with a core group of professionals who are dedicated to service excellence. The firm's advisory expertise includes activity-based costing, succession planning, estate planning, business valuation, benefit plan auditing, and retirement planning.

For additional information, visit www.barnesdennig.com.

About the Author: CHRIS E. HARTLE, CPA



Chris is a senior manager and team leader for the construction client service team at Barnes Dennig. He has worked on and led client service projects to provide audit, tax, and advisory services to the firm's clients specific to the construction industry. Chris's expertise is focused on navigating contractor financial statements, helping clients delve into the numbers and understanding the complexities of the construction industry – which leads to solid advice and greater knowledge for his clients.

His experiences range from working closely with a number of clients to identify accounting improvements and streamline processes and systems to operating as an outsourced Controller for a local contractor.

Chris joined Barnes, Dennig in 1997 after graduating from Miami University with majors in both accounting and finance. He is also a Certified Public Accountant (CPA) licensed in the state of Ohio. He holds memberships in the Ohio Society of Certified Public Accountants and the American Institute of Certified Public Accountants.

Contact Information:

chartle@barnesdennig.com

513.241.8313

ABOUT PROFITCREW



ProfitCrew is an association of accountants and business advisors dedicated to helping contractors build profitable businesses. ProfitCrew achieves its mission by providing members with highly specialized technical resources, thought leadership and professional development opportunities, empowering them to better serve the construction owner's business needs.

The sole focus of ProfitCrew is on improving the profitability of our construction clients. ProfitCrew's member firms know the intricacies of the construction industry, and they focus on the issues that concern clients most: business growth, project cost and cash flow – all the factors that impact the bottom line!

ProfitCrew member firms share resources and knowledge to help their clients address the following critical challenges:

- Benchmarking to industry standards
- Cash flow and retainage
- Cost segregation
- Estate planning
- Financing
- Forecasting
- Hardware and software selection and implementation
- Internal control/risk analysis
- Job costing
- Succession planning

In addition, the construction industry-related training provided for Barnes Dennig Construction Client Service Team members makes us better advisors to our contractor clients. Plus, hands-on Best Practices Guides give us the resources we need to move beyond the numbers and keep our clients ahead of their competition.

For additional information, visit www.profitcrew.com.