

Improve Your Cash Flow

by Leslie Shiner

Many contractors complain bitterly about their lack of cash flow. That's no surprise, given that employees, subs, and vendors all expect to be paid — whether or not the customer has paid the company.

This problem would not exist if customers paid up front, but in some states it's illegal to front-load construction contracts. Even where doing so is allowed, not every customer will agree to do it. The fact that most construction companies are underfunded to begin with only makes matters worse. Once cash-flow problems appear, they tend to multiply and lead to a vicious cycle.

Cash Crunch

One contractor client of mine experienced nearly catastrophic cash-flow problems because a customer who had started out paying promptly began taking longer and longer to pay each invoice. When the contractor asked what was going on, the homeowner told him, "Look, I'm out of cash, but I promise to pay you as soon as my additional financing comes through. But I can't get financing until the project is finished, so the quickest way for you to get paid is to finish the job quickly."

The contractor had foolishly allowed himself to get in so deep on this job that he felt the only way to bail himself out was to go along with what the customer wanted. But finishing the job meant covering his payroll and payments to subs and vendors out of his own cash flow — which turned out to be insufficient.

In the end, my client managed to keep his company afloat and to collect partial payment, but he still lost money because he had to pay significant interest and penalties on his past-due bills.

If only he had taken a few simple steps early on that could have helped him manage his cash flow, he would have saved himself a lot of trouble — and money.

Bill Early, Bill Often

It takes a lot of paperwork to run a construction company, much of it related to ordering and paying for material and labor. Billing the customer requires substantially less paperwork — yet many contractors seem

to put this task off. If you are going to succeed in business, you need to put as much time and effort into asking for money as you do into paying the bills.

Too many contractors invoice customers once a month, or when they notice they're short on cash. I tell my clients to get into the habit of creating invoices weekly. This doesn't mean that everyone pays once a week — some jobs might be invoiced every other week. The trick is to stagger the invoices: Bill half the customers one week and the other half the next. What's important is that you request cash from at least one client every week.

The shorter billing cycle not only brings cash in more quickly — it also functions as an early-warning system. If the customer can't — or won't — pay, it's better to find that out when he owes you for only a week or two of construction than when he owes you for six weeks of work.

It's also more profitable in the long run to invoice frequently. Why? Because if you collect from clients frequently, you will be able to take all vendor and supplier discounts and avoid having to pay penalties for accounts past due.

Pay Attention to Billing Methods

Cash flow from progress billings is different from cash flow from T&M billing or milestone billing. But whatever method you use, be sure to time your billings to match your cash requirements.

Start by determining which bills you need to pay when. If you have more than a few employees, the cash needed to pay them is probably your first priority. You may want to separate the invoicing process so that customers pay for labor weekly and receive invoices for the subs and materials only every other week.

Milestone billing. The problem with milestone billing is that it is often structured so that the contractor gets paid only upon "substantial completion" of a particular phase of the project. Unfortunately, "substantially complete" might mean different things to the contractor and to the client.

For example, if payment is due upon completion of

drywall, and you can't finish one of the ceilings because the recessed light fixture is on back order, the client may believe he doesn't have to pay until that ceiling is done. So you'll have to either wait until the ceiling is complete to get paid, or convince the client that the drywall is substantially complete in spite of that one missing ceiling.

To avoid having to haggle about when things are substantially complete, tie payments to the start rather than the end of a phase. For example, instead of keying the payment to the completion of drywall, key it to the beginning of interior trim. As soon as the doors are delivered and one of them is installed, no one can reasonably argue that interior trim hasn't begun.

Progress billing. Progress billing — also called percentage-of-completion billing and AIA billing — is preferable to milestone billing because it more closely ties payments to expenses.

With progress billing, you break the job into smaller phases, such as demolition, framing, and finishes. When you invoice, you determine what percentage of each phase has been completed since the last invoice and bill accordingly. Since phases overlap, you will likely bill for more than one each month.

Many small contractors shy away from percentage-completion billings because they think it's too much work and requires giving too much pricing information to the client. But progress billing can significantly improve cash flow and is not that difficult if you limit yourself to a small number of very general phases.

Furthermore, with this kind of billing, you can front-load the prices — that is, take money from phases that occur late in the job and use it in earlier phases.

With progress billing, it's important to invoice for change orders as soon as they happen; don't wait until the end of the job to bill for them.

Use OPM

OPM stands for "other people's money." Many small contractors end up covering their clients' expenses; then they simply hope to get paid. This makes it hard to maintain cash flow and puts the contractor into a position where he's one bad job away from going out of business.

T&M (or cost-plus) invoices can be timed to your advantage so that you can use other people's money. First, you purchase the materials; then you invoice the client; next you receive the money from the client; and finally you use the client's money to pay for the job costs. If you time this sequence right, you will be paid by the client before your payments to vendors are due (see "Accrual vs. Cash Accounting," *Business*, 10/04).

Credit cards. Sometimes, however, the timing is too tight or the vendor requires a deposit or cash up front. In this case, careful use of credit cards can help, but only if you are sure you will be able to pay the bill when it's due. The finance charges and late fees from an overdue credit card payment can be enough to put a struggling contractor over the edge.

If you do choose to use credit cards, you can control your billing cycle to improve your cash flow. For example, if your card's cutoff date is the 20th, make your purchases on the 21st of the month. That way, you have one month before the bill arrives, and often two to four more weeks before it's due.

Take All Discounts

Many vendors and suppliers offer discounts for early bill payments. These discounts may seem small, but they can add up to a significant amount over the course of a year. To improve your ability to take advantage of such discounts, learn your vendor billing cycles.

I know contractors who routinely wait until they've received all the bills for each

month before creating invoices for the client. This means their invoices don't go out until about the 5th of the month — so even if the client pays within a week, the contractor misses the 10-day window for taking the vendor discount.

My recommendation? Don't wait for all the bills. Invoice clients by the 25th of each month. That way, you'll be able to use the client's money to take advantage of the early-payment discounts.

Keep Track of Overbilling and Underbilling

Front-loading a contract or invoicing a client for work that isn't yet done is called overbilling. This can certainly boost cash flow — but it may be illegal in some states.

That said, overbilling is common practice for construction companies.

If you do overbill, it's important to account for it in your P&L statement. Overbilling can cause you to overstate your profit, increasing the chance you'll run out of cash before the end of the job. Contractors who routinely overbill and do not manage the process often end up using tomorrow's cash (overbillings) to finish today's jobs.

Underbilling — doing the work without invoicing the client — is even worse. I was once in a contractor's office when a client called to complain about the invoice. His complaint? That an invoice had not been sent!

If you want to maintain good cash flow, you need to avoid getting behind on your paperwork. That means sending out invoices as soon as possible.

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