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Focus on Financial Protections Before the Economy Slows Down

By Robert Mercado and Christopher Sisk | Wednesday, October 30, 2019

The U.S. is currently in one of the longest economic recoveries in its history. Because of this many contractors are experiencing the best years in their own histories. Backlogs are at record levels, and the gross profit expected to be earned on these backlogs are very promising. Unfortunately, as past market trends have proven, what goes up must come down. It is crucial that contractors take a proactive approach and employ preventative measures to prepare for the inevitable financial pivot.

Many contractors focus on the company's volume in topline revenue. This is a viable approach under normal circumstances when gross profit is consistent; however, when entering an economic slowdown, it is also normal that gross profit is impacted in the bids for new work. Every winning bid poses the risk to the contractor that the job will cost more than the original estimate. Contracts that are won with lower gross profits to sustain topline revenue creates greater risk to the contractor's financial stability.

Instead of focusing on topline revenue, emphasis should be on reducing overall cost to the company. Internal best practice would have the contractor continually reviewing costs for possible reductions or cost savings (value engineering) in an effort to increase profitability and the financial strength of the company. When the economy begins to slow down, this practice is critical.

Contractors should have a cost-cutting punch list at the ready for use in the event gross profit on new work begins to deteriorate. This prevents the contractor from being put in the position of "buying work." Buying work is when a contractor deliberately reduces anticipated gross profit on a potential project to ensure winning the bid; however, this potentially results in taking work that will not cover the company's overhead or, worse, taking work at a loss.

Contractors should anticipate market fluctuations and have a clear understanding of the cost of the company's overhead compared to the anticipated gross profit. This will provide the owners with the break-even point needed to secure a gross profit to cover the overhead and cover the company's obligations, such as debt.

A vital ratio to aid a contractor in this practice is tracking general and administrative expense as a percentage of revenue. As revenue begins to decrease, the general and administrative percentage of revenue will increase.

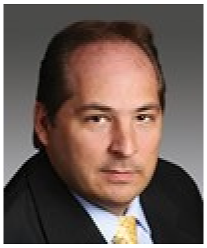
In addition, the total general and administrative expense for the year should be compared to the company's backlog gross profit. This informs interested internal and external parties of the company's ability to cover its overhead expenses based on current contracted work.

Contractors must have effective accounting systems that can track and maintain accurate data to guide the decision-making process. Without this, contractors risk being unprepared for economic downturns, which can have an immediate and substantial impact on the financial strength of the company.

While the economy and profits continue to climb, contractors should consider reinvesting a reasonable portion of their current profits. It would prove beneficial to invest in technological advances in the company's segment of the industry. Technology innovations are beginning to have a significant impact on the construction industry. As this trend accelerates, contractors should become adept at improving the efficiency of how they deliver services to their clients. Higher efficiency decreases the impact of risk to the company when there is economic change. This, in turn, allows contractors to set themselves apart from the competition.

Many contractors have large deferred tax-related items, such as section 179 and bonus depreciation on fixed assets and methods used for construction contracts. When the economy slows down, purchases of fixed assets likely reduce, and deferrals related to construction contracts fall short. Contractors need to understand the impact of the current benefits of tax deferrals and determine if those deferrals can be sustained. Should this not be possible, the company's financial statement profits may be lower than its taxable income. Contractors who are uninformed and unprepared will reel from a financial deficit.

The economy will inevitably begin to slow, given historical patterns. It is best practice for contractors to prepare for this eventuality and determine what actions can or should be taken now to secure the company for continued success.



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