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Cash Is Still King: The Importance of Projecting Cash Flow

By Robert Mercado and Michelle Johnson | Thursday, November 5, 2020

There is an old adage in the accounting and construction industries: Cash is king. Contractors understand that controlling cash is paramount to running a successful company. To avoid becoming too highly leveraged, safeguards are implemented to manage cash flow.

The majority of commercial construction contracts require the customer to pay the contractor 60 to 90 days from receipt of requisition. The customer typically retains a certain percentage, referred to as retainage, from the requisition, as prescribed in the contract. As a consequence, the contractor will undoubtedly incur costs and potentially will be waiting more than 60 days before payment is received.

For the snapshot illustrated below, assume the following facts: A contractor incurs costs of construction of $1,000 during the first month and $3,000 over each of the following three months. The contractor requisitions the customer at the end of the first month for $2,000 and in each of the following three months for $4,000. Retainage is held at 10% on the requisitions. Payment is required within 60 days of the requisition date. The following is an illustration of the cash flow based on the facts presented:

	Month 1	**Month 2**	**Month 3**	**Month 4**
Requisition Sent to Customer	$ 2,000	$ 4,000	$ 4,000	$ 4,000
Cash Received on Requisition	$ -	$ -	$ 2,000	$ 4,000
Retainage Withheld by Customer	-	-	(200)	(400)
Cash Disbursement	(1,000)	(3,000)	(3,000)	(3,000)
Net Cumulative Cash Flows	**$ (1,000)**	**$ (4,000)**	**$ (5,200)**	**$ (4,600)**

This example shows that during the first four months of a project, the contractor can be in a negative cash flow position, which would require the contractor to have enough cash on hand or the ability to access cash through a line of credit to fund the project.

LINE OF CREDIT

As shown above, many contractors will necessarily have to open and access a line of credit (LOC) with a financial institution in order to fund projects. Many LOCs are available based on a prescribed borrowing base calculation up to a certain limit. The borrowed amount is calculated as a percentage of outstanding contract receivables owed to the contractor. LOCs are short-term borrowing facilities usually with a requirement to be paid off in full at least once a year. If the LOC is not paid off, this could indicate that the contractor is undercapitalized. An undercapitalized contractor could have difficulty meeting cash flow needs and may require additional long-term debt or an infusion of capital from the owners of the construction company.

SCHEDULE OF VALUES

The schedule of values (SOV) is a detailed list supporting the various components of a project. A price is assigned to each item, providing the total contract value.

The SOV is created by the contractor at the start of a project and approved by the customer. As the project progresses, the contractor will requisition the customer. Each requisition to the customer shows the percentage completed for each component of the project, providing the amount that can be requisitioned to the customer. Upon receipt of each requisition, the customer will review the schedule of values to ensure the contractor is requisitioning at the percent complete agreed on at the start of the project. If the customer disagrees with the percent complete on a component or various components of the SOV, the customer will reduce the requisition down to the percent complete that the customer believes is accurate for each component. Therefore, it is critical that the contractor focus attention on the SOV to ensure that, as the project progresses, requisitions sufficient to cover costs and profit and deliver positive cash flows can be generated.

FRONT-END LOADING

A common practice contractors use to increase cash flows at the beginning of a project is front-end loading. This is the practice of placing more profit on items in the SOV incurred at the start of a project, such as mobilization costs.

Scheduling more profit on earlier components of a project will increase cash flow at the earlier stages. The drawback to this method is that the requisitions at the project’s later stages could produce little to no profit, showing lower billables than the contractor’s cost in those stages. To monitor the status of cash flows on a project, it’s important to project future cash flows on a project-by-project basis. Otherwise, front-end loading could prove catastrophic if the contractor lacks available funds to complete the project.

FUNDING OF LOSS PROJECTS

Contractors should analyze available cash flows on a project-by-project basis. Being prudent in this will ensure each project is heading toward or remains in a positive cash position. A simple calculation of cash flow on a project-by-project basis is taking the amount the contractor requisitioned to the customer and reducing it by the amount of receivables outstanding on the project. The reduced amount is then subtracted from the cost incurred to date less any amounts included in accounts payable. Contractors that borrow funds paid on a profitable and/or positive cash flowing project to fund a poorly performing or negative cash flow project risk not having that cash available to complete the profitable project.

CONCLUSION

Aggressively requisitioning the customer for work and front-end loading could be great ways to increase cash flows and reduce the need to borrow cash through a line of credit or owner cash infusion. Proper attention to the SOV and project analysis can eliminate future cash flow and project completion issues for the contractor. Implementing these practices can mitigate potential cash flow setbacks on a project, while increasing profitability and longevity.

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