

Can You Handle That Job? Richard E. Gavin, CPA

Across the industry, backlogs are shrinking and there are few new projects are up for bid. While there are some encouraging signs that may indicate a rebound has started, that has yet to result in more projects ready for bid. Contractors have been forced to expand their scope in search of new projects. They begin to look in areas they would not ordinarily venture to in better times such as:

- Expand geographic reach
- Different types of projects
- Different project owners
- Different size projects (larger or smaller)
- Joint ventures

Of particular concern to project owners are contractors bidding on projects that are significantly larger than the projects they typically perform, and significantly larger than their previous largest contract completed. How does a project owner evaluate the financial ability of a contractor to complete a project? This is a critical question that project owners must consider in awarding projects. The risk of the contractor not completing a project is a significant increase in the cost of the project, extensive time delays and costly litigation, just to name a few.

The assessment requires analyzing the financial strength of the company, its liquidity, and the cash flows from the project. Contractors typically go out of business because they run out of money, not because they run out of work. A common scenario would involve a contractor with a healthy backlog taking on a new project that is significantly larger than any previous project. One of their current jobs goes bad and starts losing money. At the same time the new project is 15% towards completion and experiences unforeseen delays. Cash flow is draining from the company, and when the cash runs out (including any owner capital infusions and bank lines of credit), the music stops and the company is out of business.

A client of ours had to address this very question of showing its financial ability to complete a project. Our client, Sample Contracting, Inc. was the low bidder on a public project for approximately \$40 million. This was by far the largest project our client has undertaken. The contractor had been in business for less than 10 years, and even in an industry with one of the highest failure rates of any business, they are a young business. The agency was concerned about the financial ability of the contractor to complete the project and proposed a series of questions. The main focus was on the projected cash flow of the project and its impact on the companies operations. We needed to show that based on the projected cash flow of the project, the company would have sufficient liquid capital, including utilizing bank lines of credit if necessary, to support the initial investment in the project until the project showed positive cash flow.

We started by preparing a projected cash flow for the new project. We worked with their estimating team to take the project work schedule and assign cost values to the production items each month. We then match that up with the billing schedule to project the monthly requisitions for the project. Next step was to project the actual cash flow of the cost items. Labor costs are paid in the month incurred, while material costs and subcontract costs would be paid in subsequent months. The receipts from billing requisitions were scheduled based on the submittal dates and the projected payment schedule. The end result was a monthly cash flow projection for the project from the initial costs to the collection of retainage. From this we could project the maximum amount of investment the contractor will make into the project and when the project will break-even on a cash flow basis.

This was then combined with cash flow projections for each of the projects in process to create an overall cash flow projection for the company. The projection clearly showed that the company's liquidity and resources were more than sufficient to support the initial investment to start and complete this project.

An additional concern to the agency was the capacity of the contractor to perform the project on schedule. We were able to use the cash flow projection to support this as well. The monthly projections showed that based on the work schedule the total production of this project in any one month when combined with their other projects was not significantly greater than their prior monthly production rates.

By taking the production schedule used for their estimates and converting that into a cash flow projection, we were able to assist our client in supporting their financial strength and capacity to complete this project. The agency gained enough comfort to award the project and the client has a new management tool to monitor its progress and cash flows.