

Ten Most Common Causes of Construction Contractor Failures

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Can you remember back to the mid to late 90's? The economy was rocketing upward and most everyone was making money. Construction was booming and sureties were willing to bond just about any contractor. It wasn't uncommon for a surety to bond upwards of 20 times working capital. Fast forward to 2002. The economy has slowed down considerably, most of the states are in some kind of financial crisis, and the amount of available construction contracts to bid are declining. Also, according to the Surety Association of America, the 2001 net loss ratio of some surety bond companies has reached triple digits. The sureties are tightening the requirements to get a bond and the less than successful contractors are finding it hard to survive. But why does a contractor fail? If you ask the CPA's and sureties of failed construction companies, I believe many of the following reasons would be offered.

1. **Growing too fast.** We've all had clients that can sell. The rainmakers bring in the business with the perception the company can handle the workload. However, if the company does not have the infrastructure to support the rapid growth it may suffer significant losses. By growing too fast the company will spread its project managers too thin, promote inexperienced employees, or be forced to hastily hire additional inexperienced project managers. Also, the accounting personnel of a smaller construction company are typically not equipped to handle the workload of a rapidly growing company. If the controls are not adequate the company may experience problems with delayed/inaccurate billing, inaccurate and/or untimely financial information, poor project estimation, and cash flow problems. Controlled growth is a much better approach to expansion. A growth rate of greater than 20% per year could be a problem.

2. **Obtaining work in a new geographic region.** Performing a contract in New Jersey is different than a contract in Texas. Logistically it is harder to manage a contract thousands of miles away than one in your backyard. Also, labor supply, subcontractor quality, suppliers, codes, lien laws, permits, labor laws, tax rates, weather and soil conditions can be dramatically different and, accordingly, may result in unforeseen costs and problems. Before bidding a contract in a new geographic region, the company should thoroughly research the various additional costs which will be incurred in the area and include in its bid. Also, gross profit is often ruined by problems with a subcontractor. In your own territory, a company knows which subcontractors are reputable. However, unknown subcontractors used on out of state contracts are the lowest bidder or luck of the draw. The company should obtain references, audited or reviewed financial statements, Dunn & Bradstreet reports, certificate of insurance, and bonds (for significant subcontracts) from subcontractors and suppliers it anticipates using for the contract. By carefully researching a new area, management will be able to more accurately anticipate costs and make the contract a profitable one. When entering a new market, a contractor should consider performing a small contract before bidding larger ones.

3. **Dramatic increase in single job size.** A contractor who continually builds \$1,000,000 commercial buildings will find new and different challenges building a \$15,000,000 building. If your company wants to increase the size of the projects it bids, consider a joint venture with a contractor who routinely completes such projects. This not only spreads the risk but also creates a working relationship for potential future opportunities. Also, slowly work up to larger contracts.

Instead of jumping from one million dollar project to fifteen million dollar projects, try a few five million dollar projects first.

4. Obtaining new types of work. Diversification is important when investing your 401(k) dollars; however, in the construction industry diversification can become your downfall. A road builder should be able to do bridge work. After all, isn't a bridge just a suspended road? Wrong! Also, a heavy highway contractor cannot suddenly build commercial buildings. Each type of construction takes unique talents and specialties. The contractor should stick with the type of work that has made them successful. However, if you want to diversify your business, start small. For example, the heavy highway contractor may bid on one small commercial building. Upon completion of the contract, management should evaluate the job and determine whether or not to continue to bid more commercial buildings. Eventually the company can grow into another niche.

5. High employee turnover. Estimators, project managers, and superintendents are critical to the success of a contractor. Sky-high turnover in key positions will result in lower job profitability and potential bidding errors. During times of increasing turnover, upper management of the company must become deeply involved in the operations to ensure reduction in estimated gross profit is minimized.

6. Inadequate capitalization. Just like in marriage, money may be one of the leading causes for a construction company's failure. Many business owners underestimate how much money will be needed, not only to start the business, but also to sustain it as it struggles to gain financial strength. Tangible working capital less than 5% of annual revenues and a poor banking relationship will contribute to severe cash flow issues. Also, the manner in which a contractor finances its long-term assets can significantly impair its ability to continue operations. In an industry that relies so heavily on working capital, taking on significant current debt to purchase equipment can hamper the company's ability to obtain a bond. A contractor, who purchases several hundred thousand dollars of equipment and finances through a short-term loan, has just reduced its working capital by the entire cost of the equipment. The company needed the equipment to perform upcoming contracts. However, because of the structure of the financing the contractor has affected its bonding capacity.

7. Poor estimating and job costing. There can be no worse feeling for a company owner than being awarded a contract and learning you left 5 – 10% on the table. Management will immediately return to the bid to see what was missed and why. Contractors must have internal controls over the estimating and job cost processes. Also, a good estimating software package is a must for the contractor. Management must carefully review bid and obtain multiple quotes from reputable suppliers. Once the contract is awarded, the actual costs must be routinely compared to the original bid in order for reduction in estimated gross profit to be minimized.

8. Poor accounting system. Construction is a specialized industry and construction companies must have specialized accounting software. The accounting system must provide monthly financial statements on the percentage of completion method with detailed contract schedules. Also, the accounting system should provide for phase coding, identification and allocation of indirect costs, and produce variance reports. Timely and accurate financial information is critical in the construction industry and without this information; a company cannot make sound business decisions. There are several good construction accounting packages that will provide management with the necessary schedules for review.

9. Poor cash flow. Cash flow is a critical component of any company, but especially a contractor. A labor-intensive contract with weekly payroll costs of \$100,000 may have \$600,000 – \$800,000 in labor costs before the company receives its first payment from the contract owner. In order for a construction company to survive it must actively manage its cash flow. Some of the strategies a company can implement to improve its cash flow are:

- Negotiate additional mobilization and payment terms into the contract.
- Front load the bid quantities to get the owner to help finance the contract.
- Negotiate the amount held into retainage if possible.
- Pre-qualifying the credit worthiness of their customers (contract owners).\
- Ensure billings are completed in a timely manner.
- Skip payment clause in debt agreements.

Management should also evaluate the cash flow of each contract. The “best of class” contractors will even evaluate cash flow on each contract by project manager. The project manager with the best positive cash flow percentage is given a reward of some type. What better way to get a project manager motivated to collect cash for your company?

10. Buying Dumb Stuff. We have all seen public companies make their “ego purchases”. A company buys the naming rights to a stadium or ballpark (Enron, CMGI, TWA, Adelphia, and PSI Net), purchases a sports franchise (Buffalo Sabers), or opens a national restaurant chain (Planet Hollywood) and then plunges into financial trouble. Construction contractors are no different. A successful contractor often will take the profits of the construction company and buy a winter home in Naples, purchase a helicopter, purchase speculative real estate, or open a restaurant. There is nothing wrong with enjoying the financial success of your company. However, if these investments turn south, often times the construction side of the business will fund the sinking venture. Management should fight the temptation to purchase such investments and “stay with what brought them - construction”.

Does this list mean that if you are a contractor and you meet two or three of the causes listed above you are destined to fail? No. However, in our experience, these are common mistakes made by the failed contractor, and you should be cautious if your company is falling into these traps.