



Accounts Receivable

You're Gonna Need More Than Luck

by Doug Irvin

Samuel Goldwyn once said, “The harder I work, the luckier I get!” Implicit in this tongue-in-cheek statement is the fact that one’s success is often linked more closely to hard work than to pure luck. When you work in the construction industry, leaving things to luck—especially your accounts receivable ledger—is not a good idea.

Accounts receivable can be the largest asset on a construction company’s balance sheet. Unlike many industries where risk is spread within the receivable portfolio, a contractor’s receivables are typically concentrated in a relatively small number of accounts—and these accounts typically change from project to project. Adding to the difficulty is the issue of retainage (the portion of a contract payment that is held as assurance that

the contract will be completed). As a result, it may take some time to collect final payment on a project. And if the project encounters problems or the owner doesn’t have the money at completion, retainage can become very difficult to collect. When delays in receivable payments occur, entire projects may be jeopardized. Yet many firms do not have a formal credit policy to manage this *very significant threat* to their business.

Even if you have a legitimate right to payment and have secured your position with liens, a delay in payment can have a devastating effect on your operations. One of the leading causes of contractor failure is “hung receivables,” due to the obvious impact lack of payment has on cash flow. Even if a contractor has enough cash to make it to project completion, the bonding company may restrict capacity or refuse to extend surety credit until payment is received. At a minimum, *the surety will discount working capital, and possibly net worth, by the amount of receivables over 90 days past due.*

Due to current conditions in credit markets and the economy in general, credit risk for the construction industry is likely to increase significantly over the next few years. How well a contractor manages his or her credit risk could mean the difference between success and failure. The following suggestions provide a framework for developing a sound credit risk management policy:

- **Pre-qualify the project owner**—The general contractor should have primary responsibility for doing this, but pre-qualifying is also a good practice for subcontractors. How well do you know the owner? Have you worked for him or her before? What is the owner’s organizational structure? If it is a single-purpose LLC or partnership instead of a corporation, you may want to investigate more thoroughly. Pay attention to the economic conditions of the owner’s industry. As an example, the ethanol industry has begun showing signs of distress; as a result, you will want to use extra diligence during the prequalification process for any project related to this industry.
- **Verify financing**—Obtain written verification from the lending institution, including details of the facility. This information is necessary whether the job is bonded or not. If the owner uses equity funds for a portion of the funding, make sure the money is in escrow or that some method is in place to ensure that the equity funds will be available. If at all possible, ask the bank for a set-aside letter so you are confident the funds are specifically dedicated to your project. It’s also a good idea to check the available funds status throughout the entire duration of the project.
- **Monitor change orders**—If a project experiences financial trouble, you do not want to be left holding unapproved or verbal-only change orders. Be certain that stringent change order procedures are in place to ensure that you receive *signed* change orders before you undertake a material portion of the additional work. Also, if the change orders for a project increase the project budget by ten percent or more, verify that financing is available to cover the increased cost before you begin work.

- **Know the lien laws and payment bond statutes in the state where the project is located**—Be certain that you have up-to-date procedures for filing liens or payment bond claims within the mandatory filing period. If you would like to receive a matrix of laws from Nebraska and surrounding states, please contact SilverStone Group at the number listed below.
- **Establish procedures for handling payment issues**—The primary objective is to stay on top of situations and control the amount of risk instead of allowing small issues to escalate. The deeper your investment in the project, the less control you have. A good way to stay in the loop is to review the accounts receivable aging schedule each month.
- **Manage your risk contractually**—Avoid clauses such as “waiver of lien rights.” If you are a subcontractor, make sure the general contractor didn’t waive lien rights in the contract with the owner and then incorporate the contract with the owner into your subcontract. Beware of anti-pass-through provisions and disputed-work clauses.
- **Seek legal counsel**—It is a good idea to visit your attorney *before* you sign change orders or other documents that may release lien or bond rights or contract claims. You should also plan to contact your attorney well in advance of mandatory filing dates. The legal cost of recovery can be much lower if your attorney is well-prepared with lien/bond rights and reservation of cost and time impacts.
- **Bill aggressively**—Remember the cynical version of the Golden Rule—“the one who holds the gold makes the rules.” Try to stay ahead by overbilling the project and either gain control or at least reduce the amount of control the owner has over you.
- **Negotiate better retainage provisions**—You might accomplish this by asking for no retainage withholdings after the job is fifty percent complete. Not only does this improve your cash flow, it also reduces the dollar amount you have at risk at the end of the project.

Establishing a formal credit risk management policy has the potential to help prevent serious receivable issues. In the event that you do encounter a problem, you may find yourself in a better position to respond to the situation proactively.

Trying to manage your credit risk without a specific plan could generate unpredictable results that are heavily dependent on luck. And while everyone gets lucky now and then, the best kind of luck is built on hard work and good planning.