On-Site

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Speeding up the payment process
Supply chain financing for construction projects

The 411 on IoT: Everything is connected

Why it's worth going above and beyond OSHA compliance

THE CONTRACTOR'S CORNER
What's the deal with this dispute review board?

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Speeding up the payment process

Supply chain financing for construction projects

Construction is historically an invoice-based industry. You get paid when work is completed, and only after the invoice is submitted along with other documentation and approved by multiple project stakeholders.

This payment process can take weeks or months, creating serious cash flow and working capital challenges for contractors who are waiting to get paid for work in which they've already invested payroll, equipment usage and materials.

Subcontractors are especially vulnerable to working capital gaps; the current strict lending climate for small to midsize businesses hampers access to quick financing at reasonable rates. But there's a way for general contractors (GCs) to alleviate the financial pain of their valued project partners while accelerating invoice payments and without depleting their own working capital. It's called supply chain financing (SCF).

How does it work?

In simple terms, SCF uses financial strategies that help buyers of goods and services (GCs) maintain or enhance their own working capital while improving the working capital and cash flow of their suppliers (subcontractors) through faster, more predictable payments. Although there are different types of SCF methods, let's focus on the reverse factoring method, also known as approved payable finance.

Here's how it works: A general contractor engages a third party to finance approved invoices on specified dates. Participating subcontractors receive their payments significantly earlier in exchange for a modest fee issued by the financer, which is tied to the invoiced amount. Once the project owner releases financing to the GC, the GC then pays the original invoice amount (no fee attached) to the third-party financer to close the payment loop.

SCF enables invoices to be paid much earlier than traditional processes do, and the fee charged to the subcontractor may compare favorably to the costs of traditional financing available to most small and midsize construction businesses because it's based on the creditworthiness of the larger GC. SCF also allows GCs to extend their payment cycles to enhance cash flow during projects, as they pay the third-party funders later in the process than they would with other options.

Why should GCs do it?

With construction booming and skilled labor shortages troubling many areas of the country, close working relationships between GCs and subs are increasingly important. GCs can use SCF to build trusted relationships by ensuring their project partners have the resources they need to successfully complete work and move on to the next job.

Consider this: It's not uncommon for subcontractors to run into cash flow problems because

How technology brought SCF to construction

Although supply chain financing (SCF) has been around for decades, the complex nature of the construction payment process has, in the past, prevented its widespread use in the industry.

Unlike many other business transactions, construction payments aren't as simple as submitting an invoice for payment. Instead, they're complicated dealings that require supporting paperwork, including certifications proving billed work has been completed and documentation related to compliance, liens and more. Add in the industry's litigious nature, and SCF financers have traditionally seen construction as a high-risk investment.

Technology has changed that perception. Construction-specific business management and accounting software solutions have standardized and automated the invoicing and payment process. Developed specifically for contractors, they track all payment activities and help ensure invoices are clean and free of liens, which is key to making invoices eligible for SCF. When these tools are cloud-based, they make invoicing more transparent, placing all participants on a network where they can easily access information. With cloud-based platforms, it's also faster and easier to add participants.

These technology tools have packaged construction invoices as fundable assets free of liens and other issues — and SCF funders have taken notice. If you're interested, a quick Internet search will bring up several institutions that now offer SCF programs to contractors.

of unpaid invoices and a tight lending market. Delays in payment and uncertainties over when payments will be received can weaken subcontractors' financial health, limit their ability to plan and mobilize, and even cause business failures.

When subcontractors default because of financial issues, GCs must face several challenges, including work stoppage and costly project delays as they seek to replace the sub in question. By employing SCF to accelerate invoice payments, GCs can stabilize their supply chains (dependable subcontractors) and build loyalty, which can bring about higher quality work in better time frames.

Meanwhile, subcontractors receive payments more quickly, often within days of submitting invoices, reducing their reliance on hard-to-acquire traditional financing. Some subs may enjoy an added benefit of being able to take advantage of suppliers' early payment discount programs.

What are the risks?

Although SCF offers the advantages noted, contractors should view it as an *alternative* to traditional financing and seriously consider it only after a careful examination of the pros and cons.

The approach has its detractors, who advise against any form of factoring because of the inevitable degree of control you'll lose to a third-party financer. Performing a cost-benefit analysis and checking the fine print of any prospective arrangement are imperatives.

Also, it should be noted that perhaps the ideal way to pay subcontractors, without incurring any outside interest costs, is to build up an in-house operating cash reserve to finance business activities.

Who can help?

There's no doubt that SCF holds promise for the construction industry — particularly as the technology facilitating the SCF process improves. (See "How technology brought SCF to construction" on page 3.) But, as noted, it may not be a good fit for every construction company. Consult your CPA for a full assessment of whether SCF is right for you.

The 411 on IoT: Everything is connected

Once upon a time, there was the Internet. And relatively speaking, it was easy to understand. The Internet was (and is) a network on which any computer on the planet could communicate with other like-connected computers, enabling users to correspond and share files.

But the Internet wasn't (and isn't) satisfied with connecting only computers. It wanted to connect your phone, too, and then your tablet and then your television. Fast-forward to today and, well, *everything* is connected — from refrigerators to HVAC to security systems. This phenomenon is known as the Internet of Things (IoT), and it's a topic on which every contractor should gain some expertise.

Do your homework

Generally, larger (or bigger budget) construction projects are leveraging the IoT's potential more than smaller ones. But, someday soon, IoT could affect even smaller jobs as more and more connected technology becomes integrated in houses and buildings.

To get started (if you haven't already), research which IoT equipment and systems are becoming commonplace, if not required, in your construction specialty. For example, if your company handles HVAC systems, familiarize yourself with the real-time monitoring and predictive maintenance capabilities now in use. Commercial and residential solutions designer Emerson Climate Technologies has predicted that, by 2019, 75% of thermostats sold will be Wi-Fi enabled. There will likely be similar growth in many other specialties.

Once you know where changes are probably going to occur, monitor those products or systems. This way, you can compare their costs to more conventional options and work up more accurate estimates for your customers.

Look for opportunities

Along with preparing to incorporate IoT technology into your projects right away, consider how it might improve your business management process long-term. There are a wide variety of IoT applications that may soon affect your construction company's operational efficiency and bottom line.

For instance, many contractors are already using IoT tech to handle fleet and equipment management. As these tools evolve, you'll be able to more readily monitor, track and record the location and efficiency of your vehicles, equipment and crews.

Sensor technology can already help flag, diagnose and schedule equipment maintenance and repair needs. Real-time activity tracking allows even more realistic scheduling and reduces the need to build in anticipated downtime. Wearable health-monitoring devices may help reduce accidents, injuries and repetitive-motion stresses.

There's also great potential for IoT in relation to inventory tracking. Some construction companies have long been using radio-frequency identification (RFID) to track building materials and equipment parts. But imagine if RFID barcodes or sensors didn't just transmit data to a local system but made it accessible via the Internet where you could check it 24/7 from anywhere. That's the power of IoT.

And don't forget the robots! Watch for developments in remote-controlled, programmable construction equipment. These machines can't replace skilled labor on a widespread basis — yet. But they're already in use to gather and transmit jobsite data via the Internet. And, at "off-site" construction facilities, robots manufacture building components with incredible accuracy.

Target training tools

IoT holds great promise for employee training, too. For example, augmented-reality goggles can place instructional graphics within a user's field of vision to help direct operation or repair activities. These can be used for both training and real-time, on-site guidance.

Each student's activities can be tracked in detail and his or her "grades" tracked on training system software. All of this results in a much more comprehensive and data-driven path to educating a skilled worker.

Plug in

Some things in construction will never change. You'll always need a certain number of boots on the ground, and there will always be concrete, glass, steel and various wood products involved in the composition of a building.

But within the skeletal framework of virtually every new structure built going forward will be an array of cameras and sensors — all connected to the Internet. Plug in to this technology now and you'll be able to more easily follow along as it becomes more universal.

Why it's worth going above and beyond OSHA compliance

Every contractor is aware of the importance of complying with safety rules set forth by the Occupational Safety and Health Administration (OSHA). There are heavy penalties and fines associated with noncompliance. And most construction businesses take steps to at least meet the minimum qualifications.

But why be satisfied with the bare minimum? There are several reasons why building a strong safety culture — one that goes above and beyond OSHA's rules — is the best way to manage the costly risk of mishaps and outright disasters.

Decrease workers' comp costs

Workplace injuries have a major effect on a company's bottom line. In its 2018 Workplace Safety

Index, insurer Liberty Mutual estimated that employers paid more than $1 billion a week for direct workers' compensation costs for disabling, nonfatal workplace injuries in 2015.

The top causes of injuries were overexertion involving outside sources (lifting, pulling, pushing, holding, carrying, throwing objects), being struck by objects or equipment, and falls. Interestingly, four of OSHA's top 10 safety violations for 2018 relate to falls.

Bottom line: Having fewer workplace-related injuries translates to stronger cash flow because workers' comp premiums and related expenses will plummet.

Recruit and retain good employees

It's no secret that the construction industry is experiencing a skilled labor shortage. The ability to attract new staff and retain employees remains more critical than ever.

A company that shows a serious commitment to keeping employees safe and healthy may find hiring and keeping good workers easier. After all, many of today's skilled workers can pick and choose from the top positions available. A construction business with a spotty safety reputation probably won't be their top choice.

Increase productivity and ROI

According to the American Society of Safety Professionals, a companywide focus on safety leads to higher worker productivity, which drives short-term revenue growth and supports long-term sustainability. Safe environments minimize lost working hours to fatigue, injury or illness. On the flip side, accidents on the jobsite can delay projects and lead to cost overruns.

In addition, according to a 2016 Dodge Data & Analytics SmartMarket report, *Building a Safety Culture*, three-quarters of construction companies with high-level safety cultures said they

experienced improvements in their projects' returns on investment. In contrast, of those companies with lower-level safety programs, 36% reported increased project ROI.

Win new work

A company that can promote its rock-solid safety record will look more appealing to project owners and stakeholders, too. In fact, the 2016 Dodge Data & Analytics report indicated that 76% of construction companies said their safety programs increased their ability to contract new work.

Although unpleasant, think worst-case scenario. A single jobsite fatality creates a PR nightmare that can hinder a construction company's ability to win new work for months afterward. Naturally, this concern pales in comparison to the human cost. Every injury prevented through your safety program is a person left whole and a career intact. Every life saved is a family preserved.

Creating a culture

Doing the bare minimum to comply with OSHA rules may save time and a few dollars in the short term. But your construction business will be left vulnerable to even the slightest slip. When you make safety a core company value and create layers of safety protections, you'll allow some room for error that can prevent the worst of the worst safety incidents.

What's the deal with this dispute review board?

My construction company recently won a bid to take part in the building of an outdoor shopping center. The project is, by far, the largest and most complex we've ever worked on. One thing that worries me is that we've already been informed that a "dispute review board" will address any major conflicts that arise. It's almost like the owners are assuming the worst. What's the deal?

For jobs as large as the one you've described, with so many parties and variables involved, surprises and disagreements become more likely. Dispute review boards (DRBs) are an increasingly common measure deployed on large projects to resolve issues in real time and prevent costly delays.

How it works

DRBs are usually established before work begins. A typical board for a large project includes three neutral industry professionals who are respected by project participants. Often, DRB members are trained as mediators or arbitrators and jointly selected by the project owner and general contractor. Many also include an attorney.

The independent board is required to stay abreast of the design and construction, attend project-related meetings and hold DRB meetings. Through this process, the board can quickly identify potential disputes while they're developing and step in before they slow or stop construction.

The board facilitates communication between the owner, designer and general contractor to address dangers such as unforeseen jobsite conditions. If the board can't motivate the parties to collaborate, it can convert into a more traditional arbitration board and, depending on the contractual agreement, make final decisions.

Cost and time savings

DRBs have been used for years in large infrastructure construction projects and public-private partnerships. Lately, they've been gaining traction for other types of construction, such as commercial buildings, multiunit residential, shopping centers and schools. For smaller projects, dispute resolution may be the job of only one person.

DRB members generally work on contract and the cost is an added upfront project expense. For multiyear jobs, this expense is a small component of total cost. Even for smaller projects, the cost of a DRB pales in comparison to the expense of formal arbitration or litigation.

The time-savings element lies in the DRB's ability to handle disputes in-house, as they occur. This is much faster than going through outside arbitration or the court system. In addition, project team members can rest assured that their construction-related disputes are being handled by knowledgeable industry professionals, rather than a jury of laypersons.

Risk-management measure

To sum up, a DRB is something you may begin to encounter more regularly as your construction company takes on bigger jobs. And it's not a reflection of mistrust in the parties involved. Rather, it's a risk-management measure designed to save everyone time and money.

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Our team has many years experience in accounting and taxation. We concentrate on construction companies, real estate development, manufacturing, professional associations, personal tax and financial planning.

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CONSTRUCTION INDUSTRY

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