Best Practices for Bidding & Billing

Navigating an uncertain market & the impact on your work-in-progress schedule

JAMES WIEDEMANN, CPA, is a director in the Assurance Services division of Marcum LLP. He provides compilation, review and audit procedures in the construction and manufacturing industries. Contact Wiedemann at james.wiedemann@marcumllp.com.

ALEXANDER LOMBARDI, CPA, is an Assurance Services manager at Marcum LLP. He provides compilation, review and audit procedures for clients in the construction and oil and gas industries. Contact Lombardi at alexander.lombardi@marcumllp.com. Marcum LLP is one of the leading construction accounting firms in the U.S., providing audit, consulting, and taxation services to clients ranging from startups to multibillion-dollar enterprises. Visit marcumllp.com/construction.

It has been more than two years since the start of the COVID-19 pandemic, and there is still no sign of when the world will return to normal. To further muddy the waters, the war in Ukraine has also contributed to the disruption of the global supply chain.

Economic sanctions and physical conflict have not only cut off and halted the production and exportation of raw materials, but the war has also crippled Ukraine's ability to manufacture.

All industries have suffered the collateral damage of the pandemic and upended global economy. The worldwide supply chain disruption has caused increased material costs and lead times. Combined with an insufficient labor force in the wake of the "Great Resignation," there is a great deal of uncertainty for business owners at this time. The potential for delays, defaults or contract cancellations has not been higher in recent years.

So where is the good news for the construction industry? The good news is contractors have the ability to protect themselves against the downsides by adopting best practices in their bidding and billing processes and building certain variables into their contracts.

In 2021, one trend on many financial statements was "fades." Contractors at large saw their estimated profit margins decrease, or fade, from 2020 to 2021. Typically, users of a company's financial statements attribute a fade to either missed estimates or poor job management, but, in 2021, that was not always the answer.

Supply chain obstacles and labor shortages were the main culprits. While estimators should consider normal price increases depending on when the job is bid versus when the project will actually start, no one could have anticipated the increases to be as dramatic as they actually ended up being.

To compound the issue, companies are not only facing cost increases of 50% or more, but delays of up to five months, exacerbating scheduling issues in an already stressed labor market.

Although the picture looks bleak, it does not mean the end of the road. Rather, it highlights the necessity of planning for these unforeseen additional costs.

To illustrate, let's assume we have a small construction company that has been in business for 35 years. Since the inception of the company, there has not been much emphasis put on accounting and estimating. The veteran management team has a lot of industry knowledge and has consistently been able to bid and perform work at 30% profit margins. Overall, the company has always ended each year with more money than it started with, and all appears to be well.

Now let's factor in the economic issues above. The company begins to see material costs rise dramatically and various delays occur. In the past, management was always able to issue a purchase order for materials needed the following week on a Friday and pick them

up the next Monday, but now they're delayed five months. On top of that, the company is having trouble securing new work as multiple industries are scaling back on developing new projects based on fear of the unknowns. With less work, the company must lay off certain employees, and others may elect to take the opportunity to retire early.

When the work is finally able to begin, the company now has trouble securing new workers, and the new workers they do find are not as skilled, causing additional time to be spent on each job. When the year ends and management reviews the accounting records, they will be surprised to see that they actually lost money in the current year.

This is seen too often: Companies that may have performed well historically, without much emphasis on their estimating or accounting teams, can quickly see things spiral out of control in an economic environment like this. So, how can one navigate these times appropriately?

A lot of the analysis of financial reporting by outside users is done on a retrospective basis, however, it is imperative for management and ownership teams to have a prospective approach. If prices are increasing and there is no reasonable end to those increases, teams must build extra contingencies into their bids or include price escalation terms and delay provisions in their contract negotiations.

One thing we constantly hear when reviewing estimates with management teams is that they customarily take their estimated direct costs and add 20% in order to calculate profit and overhead. However, if material costs rise in excess of 20%, the company will see that margin become a loss very quickly. Therefore, companies need to estimate additional costs now and potentially increase the 20% add-on to be 30% or more.

Other elements, such as increased lead time to receive various products and the strained labor market, also need to be factored into the bid, or companies could also see liquidated damage provisions come into play as projects are delivered late and are assessed as penalties.

It's important to be aware that on a lump-sum project, an owner isn't legally obligated to approve a change order for these increased costs unless there is specific language in the contract explaining that. Therefore, we've seen a lot of companies attempt to put language into contracts whereby these cost increases for the various materials will be shared with the owners and extensions will be granted for certain long lead times on products.

Companies should also be cognizant of the overall impact this has on their work-in-progress schedule. If the company experiences increased costs that aren't accounted for properly, the profit margin will eventually decline and a fade will be recognized. This not only means you've paid taxes on "income" you were never going to have, but your bonding or surety agent may start to shorten their leash.

The total estimated costs to complete on projects should be reviewed as often as possible in order to identify these issues early. This will also help the company determine the appropriate progress billing. If the owner of the job isn't willing to approve change orders, it is even more important that you stay ahead of your billing process so that you have increased available cash flows to assist with the increased costs.

Otherwise, contractors run the risk of financing job costs out of their own pockets, further burdening the company's working capital or even increasing the potential for losses from interest expenses on borrowing capital.

Unfortunately, no one can predict when the world will see pre-pandemic conditions again.

Until then, it is essential for contractors to be diligent in estimating the true cost of a project. Companies can and should take the appropriate steps to protect themselves from further losses by focusing on what is already known.

Without this focus and preparation, contractors run the risk of watching their jobs fade further, and the outcome for the work-in-progress schedule can become detrimental to the entire business. ▲