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Taming Uncertainty With Your WIP

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A contractor's work-in-progress (WIP) schedule can be a window into current and projected job profitability, project cash flow, and backlog. The WIP provides a pulse of each project and a 360-degree view of the historical, current, and future states. And because of these characteristics, it's imperative to maintain realistic, up-to-date information within the WIP.

This article covers the historical, current, and future job states; how they are important to WIP analysis; and how consistent communication about the WIP is valuable to your company.

JOB STATES & WIP

Historical and current job data can paint a clear picture of where a company thrives or struggles, which can be used to narrow the lens. The future state offers a thorough examination of under-billing and variations between estimated and actual expenses.

Historical & Current States

The *historical* state illustrates the actual job-to-date performance of the project, while the *current* state focuses on real-time insight into job profitability. Both views create transparency that allow management to adjust to identify opportunities to gather as much revenue as possible (as a result of timely change orders) and maintain profit or manage fade before it's too late.

Depending on the type of project, you may have a short window of time to identify and mitigate issues with minimal cost and time lost.

Subindustry Classification

If projects can be categorized into specific subindustries (e.g., residential, commercial, industrial, governmental, private sector), management can break down the WIP schedule and further analyze profitability by subindustry.

This could help contractors visualize focus areas and highlight potential growth opportunities if resources were shifted to more profitable areas. Doing this illustrates a *build what you know* strategy, which is particularly helpful in uncertain economic times and when skilled labor is difficult to find.

Future State

The *future* state provides a deep dive that helps identify underbilling trends and changes in actual vs. estimated costs to improve the outcome of the project. This state can also help facilitate backlog management.

In times of economic uncertainty, it's important to focus on not only the current backlog, but also the status of potential jobs in the pipeline. It's essential to consistently stay abreast of how many jobs could potentially be canceled and how many will be carried out. For those that will stay on the books, any changes to project start dates and duration should be noted.

For example, a project that was planned to start in the current year may be delayed two years to allow for market recovery or stabilization. This project still belongs in backlog but should be excluded from any short-term budgeting. Budgeting in a recessionary environment also may include reserving a portion of the backlog with the potential of jobs to be put on hold or canceled.

During this uncertainty, an evaluation can also help manage profit margin by taking a pre-emptive approach to the changing norms. Having a solid gauge on workload enables a proactive scheduling approach to combat the ongoing labor shortage and supply chain challenges.

The current labor climate places many constraints on job profitability. Contractors may not have sufficient in-house resources to complete their workload on time and may be forced to pay overtime or hire subcontractors to complete the work at an even higher cost.

Supply chain bottlenecks can also cause timeline delays, potentially triggering liquidated damages. Extra consideration may be required related to the procurement process to help avoid preventable charges. Thoughtful, long-term scheduling can help avoid these circumstances and begins with having a good grasp on workload.

HOW TO AVOID COMMON PITFALLS

To help WIP reach its full potential and increase the return, here are some ways to avoid common pitfalls.

Track Committed Costs

It's key to understand and monitor the commitment of costs through subcontracts and purchase orders. These items are often lumped into total estimated costs and then the detail disappears. Itemizing and then tracking what has been committed against the budget helps determine project costs left to complete and monitor potential overruns.

Don't Rely on Overbillings as a Profit

Educating operations to understand there is a balance to overbillings (i.e., the cash flow to be used to fund the remaining work) can be a hurdle. Although it's the preferred cash flow position, project managers should not rely on an overbilling to profit the project, as this can lead to bankrupting the project.

Significant overbilling, especially on longer projects, can lead to job-borrow; this happens when a contractor mistakenly assumes that cash sitting in the bank is profit and uses it on something else, unintentionally driving future cash flow problems.

For example, if management obtains significant funds due to early overbilling and subsequently spends it faster than anticipated, then cash flow could dry up on that project if additional billings are not accepted by the owner.

Use Accurate Rates in Bids

In volatile or inflationary pricing environments, internal standard rates should be as current as possible when estimating costs for a project during the bidding process. If the standard rates running through the WIP are significantly different than the costs actually incurred, then large pricing variances will exist in the income statement.

An example of such variances can be related to labor. Recently, construction wages have been rising, and using an outdated standard rate that does not account for this increase in the bidding process can greatly hinder actual job profitability and performance, as well as reflect erratic changes to the bottom line on a monthly basis.

Ensure Data Accuracy

Inaccurate data can create significant issues within a WIP report.

Automate Data Entry

Automate as much as possible to help reduce potential mistakes. If automation is not possible or desired, then a level of review should be added to catch glaring errors with the intent to present a materially accurate WIP schedule.

Reduce the opportunity for human error in data entry; a decimal point in the wrong place, a missed zero, or a simple typo can drastically change the outlook of a project.

Ways to Avoid Common Pitfalls to Help WIP Reach Its Full Potential

- Track committed costs
- Don't rely on overbillings as a profit
- Use accurate rates in bids
- Ensure data accuracy
- Hold effective meetings for project updates

Timely Data

The importance of reliable, timely data should consistently be stressed to all levels, from estimators to the field, project management, and project accountants. Falling behind on change order updates, billings, and cost data entry does not provide good information to generate the WIP schedule and can lead to poor forecasting and decision-making; this can create a chain reaction to unwanted financial surprises and potentially undesirable strategic decisions.

In addition, generating a WIP schedule more often can provide insight into issues and give you more time to rectify them before the budgets are already spent, but this insight is only worthwhile to management if the data inputs are as real time as possible.

Hold Effective Meetings for Project Updates

Identifying the common project issues that affect WIP financial reporting issues early can potentially result in higher job margins, increased profitability, and improved internal and external relationships. An effective way to manage this issue is to have regular WIP meetings to discuss what the data shows and its accuracy.

At a minimum, an accounting and operations representative should communicate on project status monthly—typically during accounting close. Doing this twice a month could also be helpful, depending on the nature and average cycle of projects. These meetings could either be formal staff meetings or quick one-on-one sessions.

In some companies, project accountants are responsible for meeting with operations and gathering all the data necessary to build a WIP report for the projects they are assigned, which is provided to the accounting and finance department for final WIP generation. Other companies have the accounting and finance department completing the entire process.

Operations representatives involved in the meeting should be those closest to the action or with the best knowledge of the real story. These individuals “live the job” and know if subcontractors are causing delays, if materials are adequate and delivered timely, how the crew is performing, and if the project is *actually* on schedule. This can often include project managers (PMs) or superintendents, and if the estimator is different than the PM, consider including estimators as well.

What Does the Meeting Look Like?

Here are a few suggestions to help facilitate the dialogue between accounting, finance, and operations:

- *Consider your meeting location.* Meeting with the operations personnel in their office rather than in the conference room may help them to be more at ease.
- *Meet in the middle.* Learn the basics of each other's language. When accounting and finance use the proper operations terminology, it builds rapport and helps guide the discussion down a more open path.
- *Show empathy.* Understand that some individuals may initially take questions as accusatory or become defensive.
- *Remember the purpose of the meeting.* As you work through this process, there will be ups and downs, but it's important for everyone to be cognizant of the bigger picture.
- *Offer possible scenarios.* Doing this while using appropriate technical vocabulary demonstrates an understanding of the basic operations world; it will be appreciated and can also help you gain credibility.
- *Consider creating a dashboard.* This tool identifies the PM and estimator and highlights each job with a section for financial information and notes. This tool can make it easier for both parties to stay on point and not rehash old information while focusing on current updates.

A maturity goal for this practice could be to house the reports on a shared drive so updates to the notes can be made and reviewed as they happen. The meetings will then become streamlined to clarify and verify the information noted.

Maintaining a collection of these dashboards also allows you to create a lessons-learned library to refer to as new work becomes available for bid in similar genres.

What Is on the Agenda?

The breadth of points to discuss in each meeting can be granular or take a 20,000-foot approach, but they should ultimately align with the company's strategic goals. Some best practices for areas to address include:

- Projects reporting greater than 100% complete
- Accuracy of estimated costs on project reporting greater than 95% complete
- Billings to date greater than the estimated contract
- Negative backlog
- Loss jobs
- Large overbillings or underbillings
- Receivable status
- Estimated gross profit on projects greater than 90% complete in detail
- Schedule status – on target or delayed
- Any potential cost issues such as claims, subcontractor performance issues, or rework possibilities

Although this list is a good starting point, other matters may come up on a case-by-case basis that are more specific and should be included as well.

What Are the Benefits?

Regular WIP meetings aren't just an attempt to take up time, and there are certainly pros that outweigh the cons of filling a slot on your calendar.

Keeping these conversations fresh leads to maintaining a better pulse on the

accuracy of job margins, which can lead to better management of any fade or also help increase any additional profit to be gained. It's important to note that just because a project is reporting a positive margin within the estimate does not mean there's nothing more to gain to beat the estimate.

Having an open dialogue surrounding job cost status is also a proactive approach to creating a space that discourages complacency, promotes an expectation to remain alert to potential issues, and works to circumvent surprises.

Timely discussions further result in more accurate forecasting because the information being analyzed has not gotten too stale, thus giving it more integrity. This type of communication can help strengthen relationships internally by demonstrating an effort to learn outside of the financial world and relay more timely financial information to operations. It also helps to gain external confidence with the bank, bonding company, and other users of the financial reporting package.

CONCLUSION

It's no secret that, in construction, cash is king. Maintaining realistic WIP information can help facilitate relationships with lenders by providing more accurate, timely data for them to approve lending transactions. And as the economy starts to tighten, the significance of these relationships and the data provided becomes increasingly important.

Historical, current, and future job states all play an active role in WIP analysis from timely mitigation of issues to backlog management. Consistent communication across all channels of the company is integral to the process to help present the full story. And making regular WIP meetings a part of the process and learning ways to analyze the data can create benefits on both sides of the table. These benefits likely will not happen overnight, but by continuing to engage in conversation, learn the language, and focus on the important pieces of the puzzle, you will be well on your way. **BP**

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