ASA's
THE CONTRACTOR'S Compass

THE OFFICIAL EDUCATIONAL JOURNAL OF THE AMERICAN SUBCONTRACTORS ASSOCIATION

WWW.ASAONLINE.COM

JANUARY 2015

Getting Paid

FEATURE

Reducing Credit Risk and Default Receivables Through Management of Lien & Bond Claim Compliance

by Scott Wolfe

Most of the time, invoices are paid well before they age to a worrying degree. But, it's no secret that getting paid (and getting paid on time) is difficult for many participants in the construction industry. This has led to construction participants having some of the highest failure rates of any industry. Because of this, Construction Financial Managers and other A/R or credit professionals can have a hard time helping companies manage, and ultimately collect, problem invoices. Typically, the unique structure of the payment chain on a construction project generates two distinct areas of concern: (i) Getting invoices paid faster; and (ii) Reducing the number of invoices that are written off as uncollectable.

While these are two separate goals, they are fundamentally linked. The longer an invoice goes unpaid, the greater the chance of it eventually being written off. In fact, in response to survey data about B2B receivables, 52 percent of the value of receivables more than 90 days overdue was eventually written off as uncollectable.

IN THIS ARTICLE . . .

- ***The longer an invoice goes unpaid, the greater the chance of it being written off.***
- ***Create a receivables management funnel that gets you paid on every project.***
- ***To get paid every time, a company needs to influence the prioritization of its invoices.***

Construction A/R Problems

Both the complexity and structure of the payment process can lead to slow or non-existent payment in the construction industry, and the tenuous financial position of many construction industry participants doesn't help invoices to get paid. Despite these inherent challenges, however, steps can be taken to minimize these risks.

Construction industry participants are in a unique position to leverage specialized security interest to dramatically reduce credit risk and default receivables. The use of these security rights provided through mechanic's liens and bond claims, can completely reinvent a construction industry company's A/R.

Extensions of labor and/or materials on credit in a secure position get paid much more often than unsecured extensions of credit. And, keeping all invoices on a project in a secured position from the start results in invoices being paid more quickly. The security provided by mechanic's liens and bond claims was specifically provided in response to the challenges and unique circumstances of the construction industry. Nearly every party that supplies materials, equipment, or labor to a construction project has the right to use the value of the property being improved as collateral to guarantee payment. This ability provides parties in the construction industry with a unique ability to combat credit management challenges.

The question, then, is how to fully use the security rights available. Creating a solid and routinely followed credit policy and developing a receivables funnel to take advantage of the security rights available to the construction industry, can result in the reducing DSOs and the practical elimination of bad-debt write-offs.

The Receivables Funnel

The first step in creating a receivables management funnel that gets you paid on every project is to understand why customers aren't paying in the first place. Why aren't solvent companies paying their bills? The truth is that they are — they just aren't paying yours. As was discussed above, the structure of payment on a construction project is convoluted and unique. Since many companies are required to float significant costs, while waiting for payment from other parties, these companies are oftentimes forced to make decisions as to which invoices to pay on time. Figuring out which bills to pay when comes down to an evaluation of which bills should be prioritized. In fact, there are software programs specifically designed to assist companies in making the determination of which invoices should receive the highest priority, and which are more easily allowed to slip.

In order to get paid every time, then, a company needs to influence the prioritization of its invoices, which can be accomplished by keeping your invoices in a secured position, and making sure that your customer (and everybody else up-the-payment chain) knows you're on the project, and that your invoices are secured. With some limited changes possible company-to-company, a proper receivables funnel for construction industry participants should be composed of the following steps:

1. Beginning of Project: Send preliminary notice to protect mechanic's lien rights and inform parties of your involvement.
2. After Account in Default: After a relatively short set period of time, send a notice of intent to lien to urge payment.
3. If payment not received within a certain set number of days after NOI sent: File a mechanic's lien to secure the debt with the property itself.
4. If mechanic's lien not paid within a certain set number of days: Send to collections.
5. If mechanic's lien not paid within four months: File a foreclosure/lien enforcement suit.

While all steps are important, very few projects will make it to the third step before payment is received. Of the projects that do make it that far, even fewer will ever reach Steps 4 and 5. In fact, if you stick to the policy of sending a preliminary notice on every project, and sending a Notice of Intent if payment is not promptly received, you can expect to actually file liens on only 1 percent to 2 percent of your total projects.

Does It Work? And How?

The process outlined above is a step-by-step checklist to remain in a secured position on every project. Remaining in a "secured position" means that the work performed or materials provided on credit, are secured (backed by a security interest in collateral). This serves to reduce the risk associated with extending material or work on credit because of the ownership right in an asset that may be claimed in the event of a default by an indebted party. In the construction industry, the collateral to secure the debt is the property being improved itself. A valid mechanic's lien allows the property to be sold to satisfy the claim — if it comes to that. Luckily for both the lien claimant and the property owner, however, it rarely does. And, the mechanic's lien security interest can also position a creditor in to recover in the face of another party's bankruptcy. This is pretty good protection.

Creating and implementing a thorough and well-crafted credit policy as a whole, (with special attention given to the notice and lien policy subparts and the receivables funnel as outlined above) is an incredibly powerful way to collect the money you are owed on every project.

In a fairly recent case-study performed on a medium-sized construction industry business ($15 million to $20 million annual revenue), the adoption of a strict receivables funnel had a profound effect on their A/R. This company decided to adopt the receivables funnel concept, and to send notices and liens on every project when required by their policy. The results of their decision to implement a concrete payment funnel were phenomenal. After adoption of the payment funnel concept, the company's uncollectable account percentage dropped below 1 percent, all the way to 0.035 percent (2010), 0.067 percent (2011), and 0.012 percent (2012). Further, and also significant, this company was able to increase business in "riskier" credit situations, and grow their bottom line. In fact, the strict adoption of the payment funnel concept fueled an increase in revenue by more than 140 percent in one year.

The effectiveness of the receivables funnel concept, and following through on the policy decision to send notice on every project, and to remain in a secured position is not limited in any way by company size. Small companies and Fortune 500 companies can all benefit by putting these concepts into use. An analysis of over 100,000 invoices from a large construction industry participant reinforces this conclusion. That analysis found that the average Days Sales Outstanding for projects in an unsecured position was 71 days, while the average DSO for projects in a secured position was 33. Further, at 90 days after invoice, 21 percent of the unsecured projects remained unpaid, while only 7 percent of the secured project invoices had not been paid by that point.

Creating and following a credit policy that incorporates a notice and lien rights receivable funnel can be the best decision your company has ever made to collect the money you are owed.

Scott Wolfe is CEO of zlien in New Orleans, La., a platform that reduces credit risk and default receivables for contractors and suppliers by giving them control over mechanic's lien and bond claim compliance. Wolfe is a licensed attorney in six states with extensive experience in corporate credit management and collections law, including the use of mechanic's liens, UCC filings and other security instruments to protect and manage receivables. He can be reached at (866) 720-5436, Ext. 700, scott@zlien.com, or @scottwolfejr on Twitter.

February ASA Webinar Focuses on Mechanic's Liens

The Feb. 10, 2015, ASA webinar "Mechanic's Liens: Protect and Collect" presented by Jerry Bailey, NCS, examines mechanic's lien laws and how subcontractors can use them to protect themselves from losses and get paid sooner. Learn what tools are available to minimize your risk. This webinar is $99 for ASA members and $179 for nonmembers. Register online.