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BY LESLIE K. HAMMOND, MICHAEL AFRICK, MICHAEL GROSS & DAVID L. SAUERMAN

# Volatile Earnings: What's the Deal?

A CFO, a CPA, a banker, and a surety walk into a bar...

Although it sounds like the beginning of a bad joke, in this case, four industry professionals sat down to jawbone about the construction industry's tendency toward volatile earnings, some of the problems that stem from this volatility, and what, if anything, contractors can do to dampen that volatility.

Participants in this conversation include Leslie K. Hammond, CFO of Lauren Engineers & Constructors, Inc.; Michael Africk, Principal of CliftonLarsonAllen; Michael Gross, Assistant Vice President of CNA Surety Corporation; and David L. Sauerman, Managing Director of The PrivateBank.

**Dave:** Over the past few years, I have observed increased short-term volatility in contractors' reported earnings. I'm not talking about the industry's normal cyclical ups and downs, but rather quarter-to-quarter results that bounce across the board. While my evidence is limited to my own casual observation, I suspect that there is a real trend emerging.

Is this observation real, or is it merely a product of my own imagination?

**Les:** Yes, it is real. Volatility in the income statement is the product of cyclical and seasonal volatility, a company's project portfolio volatility, and individual project volatility.

Project portfolio volatility comes from the fact that the timing of major projects in backlog does not produce a smooth revenue or cost curve; projects happen when they happen. Depending on the size of the contractor, a more diverse portfolio can create a smoothing effect, but is not common for most contractors.

While individual project volatility is a more specific topic, this fundamental source of volatility is compounded by the other two components. (Your imagination might be a fourth component.)

**Dave:** Is this volatility any different today than it was five, 10, or 20 years ago? It feels like the answer should be "yes."

**Les:** I don't think that the seasonal and economic cycles have changed much. Portfolio volatility has always existed, so most of what we see is probably tied to individual project volatility. The swings in both the timing and costs that occur as projects progress are tied to productivity, labor costs, and variances in procurement buyout.

**Mike A.:** I agree that volatility is on the rise and will likely get worse before it gets better when the new revenue recognition standard is implemented. (Nonpublic entities will apply the new revenue standard to annual reporting periods beginning after December 15, 2018.) The new standard could create additional interim volatility as contracts are potentially split into multiple performance obligations. Although not every segment of a contract will be split into a new contract, we do expect an increase.

**Les:** Transparency in construction is on the rise, which may be increasingly exposing this volatility. With the vast amount of open-book capabilities currently available, volatility is instantly visible.

**Mike G.:** I have seen a definite increase in short-term volatility, primarily due to the tendency of outside parties to shift as much of the risk as possible down the contracting chain. Contract specifications (e.g., consequential damages and long-term warranties) have become more onerous. Scope changes have been on the rise and completion times continue to be compressed. If you add broader economic challenges (e.g., government shutdowns, budget shortfalls, spending freezes, and project cancellations), then it is no surprise that we are seeing more volatility.

**Dave:** Les, I'm not sure I agree that portfolio volatility has stayed the same. As Mike G. just pointed out, projects seem to have a greater chance of getting pushed back than ever before, and government project owners seem to be operating under even tighter budgetary constraints. For instance, the governor of Illinois has implemented a spending freeze and is currently reviewing many previously awarded contracts. Many private owners seem to want to delay making any commitments as long as possible, as well.

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**Les:** Let me clarify; contracts can “stack up” in the backlog rather than conveniently phased. This age-old problem becomes even less manageable when owners are more likely to delay.

Mike G. described a number of influences that create increased risk, which makes contract execution much more critical. Another environmental factor that impacts performance is workforce quality. Especially in highly active markets, where wage escalation is significant, a contractor’s historical experience with productivity may not hold up. This is particularly dangerous when project durations and contract terms are tightening.

**Dave:** Specifically, what are you seeing in these highly active markets?

**Les:** We’ve seen a high rejection rate in onboard skills testing, which puts pressure on schedule adherence because too much time is spent qualifying hires. Then, once they are hired, a significant amount of job-hopping tends to occur as employees move from one contractor to another seeking pay increases. This causes real productivity issues.

**Mike G.:** During the recessionary cycle, margin compression was present in most construction sectors. Many companies opted to sell projects at a reduced margin and eliminated contingencies from their estimates. In addition, given the buyer’s market for construction services, many aspects of the project experienced dramatic changes in the risk profile. This included onerous risk-shifting contract language, incomplete specs and plans, a shift toward price-only buyout, and a general lack of adherence to project schedules.

Eventually, the higher risks and lower margins resulted in lost profits and poor cash flow. As the markets have recently

shifted away from a buyer’s market, why is the current volatility equal to or worse than five years ago? Many contractors are gearing up for larger and improved backlogs, but with weakened balance sheets. Acquiring a large backlog, even with better margins, can actually translate into less overall earnings since the contractor may not have the financial means to effectively mitigate risk.

**Mike A.:** Based on what I am seeing, there are two primary reasons for this volatility – the increased number of changes or modifications to contracts along with more time between change order submission and owner approval.

The delay in approving change orders not only causes cash flow issues for the contractor, but it also creates a delay in recording profit on a change order. In most instances, accounting standards require a contractor to defer profit recognition until a change order is approved. Once approval is received from the owner, profit on the change order is recognized. The timing of when profits from change orders are recorded usually creates volatility on contractors’ financial statements. Combined with the trending increase in the number of change orders, this issue further compounds the potential for volatility.

**Mike G.:** Shrinking completion time and fast-track projects are on the rise; both lead to increased scope changes and may be due in part to less experienced talent managing projects.

**Les:** Incomplete plans and drawings and lack of adherence to schedules are related. Owners are anxious to get their projects off the ground and producing. One option is to compress the front-end design and engineering stage, but this presents obvious dangers and often increases the likelihood of scope changes during execution. This pattern creates a host of scheduling, procurement, and rework risks, and it ultimately increases the likelihood of contract disputes.

**Dave:** As I understand it, here’s what we’ve covered thus far:

- Volatility in earnings appears to be increasing, though this observation comes from our own experiences rather than any empirical studies.
- We see cyclical volatility, though we all agree that it has existed for a long time and always will.
- We see increased project-specific volatility resulting from increased risk shifting, low margins, lack of adherence to project schedules, and increases in scope changes.

## On the Horizon: Performance Obligations

While the FASB’s current guidance permits a contractor to treat certain contracts as a single performance obligation, it also suggests that the contractor will need to exercise judgment in determining whether or not to separate obligations. Depending on the margins built into each of the segments, the more segments or performance obligations identified and segregated, the greater the chance for volatility.



- We see increased portfolio volatility; Les said it best when he referred to the “stacking” of projects, which impacts productivity and therefore earnings. This may be further exacerbated by additional margin compression from a tight market.
- We have certainly seen the impact of an overheated market on earnings volatility. The most extreme example (until recently) has been the economic boom in places like North Dakota.
- Lastly, Mike A. mentioned the volatility that may result from the adoption of FASB’s new revenue recognition standard, which also may serve to magnify the impact of delays in dealing with an increased level of change orders as profits and costs are increasingly mismatched.

So, is this increased volatility a problem for the construction industry? If so, how does this problem manifest?

## Volatility is not typically good news for contractors, but that can change if given the right management, oversight, and approach.

**Les:** From a management standpoint, increased visibility provides a basis for better decision-making. That said, volatility also creates challenges in providing adequate liquidity for seemingly temporary needs. It presents a huge challenge in properly scaling capital and credit sources when the time horizons for various sources do not align with the swings in activity level.

**Dave:** Let’s say a contractor has both high volatility and high visibility. Is it a problem that the contractor’s results bounce around if it can accurately predict the timing and size of the bounce?

**Les:** It presents a challenge with right-sizing working capital because the contractor is providing capital for short-lived peaks. Often peak demands will outstrip the covenant provisions of primary credit facilities, while junior or equity solutions bring higher costs and longer time horizons.

**Dave:** After the financial meltdown in 2008-2009, regulators faulted the banking industry for its lack of properly recognizing the risks associated with its various loans and investments. While the industry certainly deserved much of

this criticism, the end result from regulators is a very rigid “one-size-fits-all” approach to risk rating corporate credit. Most banks now operate with a fairly simple set of metrics for risk rating their borrowers’ credit.

Although this tends to work well for stable businesses, it leaves a lot to be desired for contractors, as their business is often anything but stable. The more volatility in a contractor’s results, the more a risk rating system tends to incorrectly identify a healthy borrower as high-risk. Obviously, it is not in the contractor’s best interest to constantly defend its creditworthiness.

**Mike G.:** From a surety perspective, increased volatility is always a concern. While it can manifest in many ways (e.g., strained cash flow, profit fades, increased leverage, and employee turnover), volatility is not always a negative scenario – just an unpredictable one. And, unpredictability can lead to new opportunities, new markets, and new customers.

If managed well, volatility can translate into higher earnings. While most contractors cherish predictability in results and approach, many others have generated surprisingly strong earnings during tumultuous times.

**Mike A.:** The impact of industry volatility is much more significant for smaller contractors than for larger ones. Typically, the key financial professional of a small- or mid-sized contractor may focus on year-end results with less attention to interim results. A large contractor typically has a larger financial staff with expanded resources and is better equipped to manage the costs and deal with the fluctuations.

**Dave:** Does technology provide a positive way to either dampen or better manage what may be unavoidable volatility?

**Les:** My sense is that technology is exposing volatility in ways not previously realized. For example, by decreasing reporting cycle time, more discreet periodic estimating can be supported to allow the ups and downs in the project life cycle to be exposed and reflected, where in past years they may have cancelled each other out. The more transparency

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that is provided and the faster the information cycles, the more extreme things appear.

**Mike G.:** Technology has provided such benefits to contractors as better understanding of costs, improved safety, and an improvement in the skills of workers. However, technology has also raised the bar for all contractors, and as such can actually increase volatility – especially for those contractors that are slow to react to ever-changing technology. For example, BIM is integral to winning and managing projects. However, this technology can also result in contractors that take on more design risk or owner demands for more compressed completion times.

**Mike A.:** Improved use of technology should complement the flow of the project and improve the ability to perform many tasks and help jobs run smoothly. Again, it seems that the efficiency improvements brought about by technology are sometimes offset by owner demands for “better, cheaper, faster.” The continuous increased adoption of mobile technologies should help speed up this process.

**Dave:** As contractors, bankers, CPAs, and sureties, it’s our job to help manage risk, not eliminate it. In fact, zero risk usually translates to zero profit. What tools does a contractor have to manage that volatility in an intelligent and profitable manner?

**Mike G.:** Talented employees are a contractor’s best tools. Good employees establish relationships, which help create repeat business and steady niche work. Good management knows how to cut overhead while keeping its strongest employees engaged during a downturn. Good companies hire bright young people and provide comprehensive training to build a future.

**Mike A.:** I agree – the best tool is human capital. I think that it starts with the proper tone at the top. If it is important to leadership, then it will become embedded within an organization.

Integrate the financial team into some of the company’s operational aspects, and bring the operational staff into some of the financial processes. A rolling 12-24 month forecast can

provide a valuable look into the future. This forecast should not be authored solely by the financial team, but should also involve other key areas of the organization.

Getting the financial team involved in project reviews, management meetings, and strategic planning issues is also beneficial. Also, formal risk management not only helps manage company resources, but also serves to clarify company culture and creates an environment that aligns leadership goals with management actions.

While there is not one tool that will fix all of the challenges that the industry faces, there are many little steps that all seem to start with good people, strong communication, and a willingness to collaborate.

**Les:** It’s true that talented people working in an environment of formal risk mitigation processes are far and away the best tools. Beyond that, the quality of communication with all stakeholders is key. While communicating early and often doesn’t change the volatility, it does make a difference in how the stakeholders react.

**Mike A.:** A contractor’s commitment to having adequate resources to monitor financial activity, establish a robust budgeting process, and forecast financial results will allow contractors to better manage their finances and understand the impact that volatility in earnings will have on their overall enterprise risk.

**Mike G.:** Volatility is not typically good news for contractors, but that can change if given the right management, oversight, and approach. In fact, several contractors have said that their best years were their most unpredictable ones.

**Dave:** These last few comments constitute a very good summary of our discussion. The construction industry is, for various reasons, quite volatile. That volatility also appears to be on the rise and brings with it all kinds of challenges.

However, a contractor’s ability to manage volatility with technology, human capital, or other valuable tools could bring a wealth of opportunities. ■

## cash MANAGEMENT



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