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Avoid Misunderstanding the Importance of Contract Ratios

By Robert Mercado and Megan Moriarty | Wednesday, May 15, 2019

Contractors are required to provide financial statements to various outside parties, such as banks, bonding companies, customers and divisions of governments for prequalification purposes. For these outside parties, the simplicity of assets being positive, and liabilities negative, is not always evident in a contractor's financial statement, which can prove to be more difficult.

To truly understand a contractor's financial statement and to gain insight into the company's strength and viability, users of this data must focus on ratios specific to the construction industry.

WORKING CAPITAL AND STOCKHOLDER'S EQUITY

Working capital is the difference between current assets and current liabilities. It is also a direct indicator of the contractor's short-term financial strength. A low working capital ratio could indicate difficulty funding current and future projects. Stockholder's equity, also referred to as the company's book value, represents the amount of contributed capital and accumulated earnings (or losses) from a company's inception. Contractors should have a minimum of 10% of total revenues for the year in working capital and stockholder's equity. Any less than this, and a contractor could be considered undercapitalized for the amount of volume they have.

TOTAL BACKLOG AND BACKLOG GROSS PROFIT

Backlog is the amount of work a contractor has in signed contracts that are either in progress or have yet to start. Backlog gross profit is the estimated profit remaining on the backlog. Although every contractor varies, contractors that perform fixed priced contracts should have backlog gross profit of 50 percent or more of the next year's overhead costs.

PERCENTAGE OF COMPLETION RATIOS

The asset, "costs and estimated earnings in excess of billings" (also known as "underbillings"), and the liability, "billings in excess of costs and estimated earnings" (also known as "overbillings"), are two items distinct to the balance sheet of a contractor and the construction industry. A contractor with underbillings on a project has incurred cost that it was unable to bill until a future time, or has overstated the estimated profit. In either case, the underbilling has a negative impact on the contractor’s financial and cash flow position. Conversely, overbilling could indicate a contractor has billed the customer in excess of the earned revenue, or that the estimated profit on the project is understated.

Often, to accelerate payment from a customer, contractors will front-end load the schedule of values on the requisition to a customer. Front-end loading is when a contractor assigns larger profits to the earlier phase work and lower or, possibly, no profit to the later phase work. This practice can have a positive effect in providing cash flow on projects; however, it can also be detrimental in analyzing industry ratios.

To safeguard against underbilling and overbilling issues, contractors should calculate various ratios specific to these accounts to determine if there are potential risks, including risks to net job borrow, underbilling analysis and cash to overbillings analysis.

Net job borrow compares the assets (underbillings) to the liabilities (overbillings). Underbillings on a project could be the result of a timing issue or a result of additional unexpected cost. Generally, a contractor’s total underbilling should be no more than 25% of working capital or 20% of stockholder’s equity. Contractors that exceed these ratios could have difficulty meeting cash flow requirements and could also be overstating profitability.

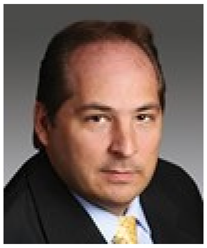
Overbillings on a project could be the result of timing or a deferred profit. Typically, a contractor will requisition the maximum amount to a project owner to receive payment, resulting in overbilling. Contractors should, therefore, be net overbilled; otherwise, there could be a significant negative impact on cash flow. Conversely, many of the largest failures in contractor history resulted from the contractor overbilling on projects and then using the overbilling to fund loss projects, or distributing the additional funds for other ventures. Therefore, the optimal scenario for a contractor is to have in cash the total amount of overbilling on all projects. If a contractor does not meet this cash-to-overbillings ratio, it is more likely to experience future difficulty funding the projects that were overbilled.

GAIN/FADE ANALYSIS

Most successful contractors will review a gain/fade analysis annually, and ideally monthly, to understand their ability to estimate projects. This analysis is performed by comparing the current estimated gross profit to the estimated gross profit reported previously on each project. If a contractor has a history of fading on projects (reduction in estimated gross profit), users of the financial statements could discount the amounts shown on the financial statements. Should this occur, the contractor’s ability to obtain financing and bonding capacity will be greatly reduced as most users of the financial statements expect contractors to perform as expected or better than the estimates on the contracts in progress.

CONCLUSION

Without a proper understanding of the ratios specific to the construction industry, contractors run the risk of compromising their financial strength. This will result in diminished confidence in the company when looking for funding, surety credit and potential customers. It is paramount that these ratios and the relationship they have on financial presence are monitored and adjusted accordingly until project completion.



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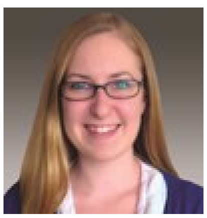

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