THE QUALITY OF NUMBERS:
ANALYZING FINANCIAL STATEMENTS FOR CONTRACTORS
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In the hyper-competitive construction industry, contractors are well aware that they must have a firm grip on all aspects of their business to remain competitive. Naturally, a primary focus is job profitability; without that, there is no business to operate. It is also extremely critical that contractors analyze their financial statements and understand the quality of those numbers. The ratios that those figures inform play a pivotal role in the prospects of construction contractors. To ensure your business’s financial standing is accurately represented and your statements paint a compelling picture, you must understand how your financial statements are used by others, including how they analyze a construction firm’s financial statements.

Typically, when contractors look at their numbers, they look at their balance sheet, income statement, and statement of cash flows, as they should. But, reaching a more thorough analysis of a business’s financial standing requires going far beyond the bottom line on these high priority financial documents. To take a deeper dive into these numbers, let’s use the following examples.

ANALYZING THE FINANCIALS

Sure, you are compiling financial data, but are you analyzing financial statements? There are many critical analytical ratios for contractors. Here are a few of the most influential:

- Profitability Ratio
  - Return on Assets
  - Return of Equity
  - Times interest earned

- Liquidity
  - Current Ratios
  - Quick Ratio
  - Days of Cash
  - Working Capital Turnover

- Leverage Ratios
  - Debt to Equity
  - Asset Turnover
  - Fixed Asset Ratio

- Efficiency Ratios
  - Backlog to working capital
  - Months in backlog

These ratios are particularly important as they are often used as the basis for prequalification and bonding purposes. In the construction industry, there are general standards and many that apply to these ratios. Those commonly applied in the industry are as follows:

**General Construction Industry Standards:**
- 10% Rule -- 10% Working Capital
- 10% Equity of Total Costs to Complete
- Working Capital -- 10-15% of Annual Revenue
- Backlog -- Equal to 1 years’ worth of Revenue
- Debt-to-Equity Ratio -- Below a 3:1 Ratio
- Underbillings -- Under 25% of working Capital
- Profit Fade -- Less than 10% of the Original Estimate
- Bonding -- 10-20 times Working Capital, 10 times net worth

Keep in mind that those reviewing your financial statements are using your numbers as a starting point for a deeper dive. To remain proactive and ahead of the curve, contractors must do the same. Let’s look at the following warning signs from the perspective of a potential financial partner.

**CONTRACTOR WARNING SIGNS**

**Significant Cost in Excess of Billings**

- Asset on the balance sheet - is it a “good” asset?
- If contracts are mostly underbilled it may be an indication of:
  - Poor billing practices;
  - Poor measurement of total job costs (which can be seen in the gross profit trend analysis);
  - Ineffective practices relating to estimating and quoting values and quantities (lack of front-end loading); and/or
  - Certain industry billing restrictions (such as input versus output measurements) that cause you to be underbilled.
**Significant Billings in Excess of Cost (“BIE”)**

- Liability on the balance sheet - is it a “good” liability?
- If your contracts are mostly overbilled, it may be an indication that:
  - Billings in excess are not recorded on the balance sheet (cash/accounts receivable); or
  - The contractor uses cash from overbillings to fund other ventures (outside of company).

Instances of BIE raise the question: If the Company has $5,000,000 of BIE, but has cash and accounts receivable combined of $4,000,000 how will that impact the ratios of the Company?

**WORKING CAPITAL & OWNER’S EQUITY**

**Working capital** is the most critical contractor ratio. It is a direct indicator of a contractor’s short-term financial strength and is used to help evaluate its ability to fund construction projects.

* To calculate working capital – *current assets minus current liabilities*

**Owner’s equity**, often called book value or net worth, represents the accumulated earnings and invested capital since the company’s inception.

* To calculate owner’s equity – *total assets minus total liabilities*

**Example A**

Contractor A has Current Assets of $1 million, Current Liabilities of $1 million, and a working capital of zero. However, assuming total assets are $3 million and total liabilities are $1 million, the complete Owner’s Equity is $2 million. Contractor A cannot fund projects. He may have equity, but that equity cannot be readily turned into cash.

**Example B**

Contractor B has Current Assets of $2 million, Current Liabilities of $1 million, and working capital of $1 million. However, assuming assets are $2 million, and liabilities are $1 million, the total Owner’s Equity is $1 million. Contractor B can have the ability to fund projects despite having less equity.

**Conclusion**

Preparing financial statements and presenting them for prequalification, lending, or bonding is not enough. As the contractor, you must take a deeper dive and understand your financials. By doing this, you will be better positioned to achieve sustained success in this hyper-competitive industry.

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