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KPIs for contractors

Finding your way with mission-critical metrics

From the baseball field to the boardroom, metrics and statistical analysis have changed businesses nationwide. And the construction industry is no exception. With proper preparation and guidance, contractors can have at their fingertips a wealth of stats-based insight into how their companies are performing — far beyond the bottom line on an income statement.

The metrics in question are commonly referred to as key performance indicators (KPIs). These formula-based measurements reveal the trends underlying a construction company's operations. As such, they can encourage you to continue on the right path or give you fair warning when you're headed in the wrong direction.

Where to start

A good place to start with KPIs is with some of the metrics that apply to most businesses. For example, take current ratio (current assets / current liabilities). It can help you determine your capacity to meet your short-term liabilities with cash and other relatively liquid assets. You generally want this ratio to be at least 1.0 — though 2.0 is an objective well worth pursuing.

Another to regularly calculate is working capital turnover ratio (revenue / average working capital). Most construction companies deal with temperamental cash flows that wax and wane based on project phases and owners' ability to remit payments. This ratio shows the amount of revenue supported by each dollar of net working capital used. Again, look to exceed 1.0.

Debt is also an issue for many contractors. You can monitor your debt-to-equity (total debt / net worth) ratio to measure your degree of leverage. The higher the ratio, the greater the risk that creditors are assuming and the tougher it may be to obtain financing or bonding. A ratio of 3.0 or lower is generally considered acceptable for many construction companies.

Job-specific data

Of course, there are many KPIs specific to construction projects. For instance, a KPI called the bid-hit ratio assesses your rate of winning project bids. Say you bid on 12 jobs and won four of them. That's a bid-hit ratio of 12:4 (or 3:1). A typical ratio is hard to pinpoint because of differing frequencies and approaches to bidding. But the lower the ratio, the better.

Once work begins, there's a lot of information you could track. One simplified example: cost variance (budgeted cost of work - actual cost of work). Specifics here will obviously depend on the budgeted and actual expenses of a given job. But a negative cost variance means that a project

is over budget, while a positive variance means it's under budget.

As your project pipeline grows, there's a backlog KPI — backlog/(revenue/12) — that can help you measure efficiency. More specifically, it reflects the number of months it will take to complete all signed or committed work. A lower ratio may mean your company needs to refocus its sales and marketing efforts to ensure a strong stream of new contracts is coming in.

Investment insight

As a construction business owner, you've made an investment in your company. Thus, there are KPIs that can help you keep an eye on whether that investment is rising or falling in value.

For example, look at return on assets (net income before taxes / average total assets). A common objective here is 15% or more. So let's say you earn a net income of $900,000 and have average total assets valued at $6 million, for a return on assets of that coveted 15%. Meanwhile, your biggest competitor across town is also earning $900,000, but has average total assets valued at $8 million, for 11.25%. Under this pleasant scenario, you're doing a better job of converting assets into profit.

An additional important KPI for business owners is return on equity (net income / shareholders' equity). It lets you know how efficiently your construction business is managing its assets and generating returns for shareholders. Generally, you want to aim for 15% to 20%. So, going back to our example, if you've earned $900,000 in net income with a shareholders' equity of $5 million, you'd have a return on equity of 18%. This isn't a terrible return but probably indicates need for improvement.

Greater clarity

As mentioned, there are many other KPIs we could discuss. The exact ones you should look at depend on the size of your construction company and the nature of its work. But every contractor needs to pick their mission-critical KPIs and set up a "dashboard" for monitoring them daily. (See "Digitize your KPI dashboard" above.) Once you do, you'll likely be able to view your operation's finances with much greater clarity.

Digitize your KPI dashboard

So you've done it. In consultation with your financial advisor and top managers, you've picked your construction company's most important key performance indicators (KPIs). Now what? You know you're supposed to keep an eye on these metrics every day but … where?

Technology has you covered. There's a specific type of software — commonly referred to as "KPI dashboards" — that allows business owners and executives to create customized views of all of their chosen KPIs. And these applications don't just lay out the numbers like a spreadsheet. They can include pie charts, bar graphs and other graphic elements to really illustrate the data.

Like any tech purchase, however, you'll need to go about this one carefully. Set a budget and compare prices and functionality carefully. As a contractor, you'll likely want a mobile option that allows you to check your dashboard on your phone or tablet at job sites.

Don't miscalculate the accounting impact of change orders

Change orders are a mixed blessing. On the one hand, they present the opportunity to make more money on a construction project because of the additional or more complex work involved. On the other, if they're mishandled, change orders can lead to conflicts, confusion and even lost money should a change go unpaid.

One place to specifically mishandle change orders is on the accounting side. If a revision to a job isn't recorded in a timely and accurate fashion, bad results may soon follow. Let's look at some of the risks involved.

Negative impact

It's not unusual for contractors to begin out-of-scope work before a change order is approved. But failure to properly account for the costs and revenues associated with this work can have a negative impact on a construction business's financial statements.

Suppose, for example, that a contractor records costs attributable to a change order in total incurred job costs to date, without making a corresponding adjustment to the total contract price and total estimated contract costs. To a surety or lender, this may indicate excessive underbillings.

Profit fade can occur if contractors are overly optimistic about their chances of receiving change order revenue. If a contractor increases the total contract price based on out-of-scope work but is unable to secure change order approval, profits may fade as the job progresses, shaking the confidence of sureties and lenders.

Categories of change

Generally, change orders fall into one of three categories: 1) approved, 2) unpriced (approved as to scope but not price) and 3) unapproved.

Approved change orders are usually the easiest to deal with — a telling reminder of why it's important to have a solid process for dealing with project changes. From an accounting perspective, it's appropriate to adjust incurred costs, total estimated costs and the total contract price. Depending on the contract's change-order provisions, doing so may increase the construction business's estimated gross profits.

Unpriced change orders are much trickier to handle. If the parties agree on the scope of work but leave negotiations on price for later, the accounting treatment depends on the probability that the contractor will recover its costs. If it's not probable, change order costs are treated

as costs of contract performance in the period during which they're incurred and the contract price is not adjusted. As a result, the contractor's estimated gross profit decreases.

If it's probable that the costs will be recovered through a contract price adjustment, the construction business has two choices:

1. Defer the costs until the parties have agreed on the change in contract price.
2. Treat them as costs of contract performance in the period incurred and increase the contract price to the extent of the costs incurred (resulting in no change in estimated gross profit).

To determine whether recovery is probable, a contractor should consider its past experience in negotiating change orders and other factors.

If it's probable that the contract price will be increased by an amount that exceeds the costs incurred (increasing estimated gross profit), the contractor may recognize increased revenues, provided realization of those revenues is assured beyond a reasonable doubt.

Last, there's unapproved change orders. These should be treated as claims. It's appropriate to recognize additional contract revenue only if, under guidance provided in the accounting rules, it's probable that a claim will generate such revenue and the amount can be reliably estimated.

Optimal shape

It's important to anticipate the possibility of change orders in your contracts. It's also important to have the proper paperwork and chain-of-approvals in place should a job change arise. But don't forget the critical role that the home office plays in change orders. By ensuring that changes are properly accounted for, you'll keep your construction company's financial statements — and financial standing — in optimal shape.

What your lender *really* wants to hear

What does every contractor's lender want to hear? Why, "The check is in the mail!" of course. But, seriously, lenders — much like sureties — expect construction companies to operate in a manner that assures both timely payments and the feasibility of future loans. Here are a few choice quotes to lay on your lender rep the next time you meet to discuss a capital infusion.

"I've done my homework."

Lenders view their relationships as two-way streets. As such, their role is to deliver quality

lending products under reasonable terms. Naturally, yours is to maintain your payment schedule. But it's also your responsibility to

provide accurate and up-to-date information regarding your construction company's finances.

Thus, your lender wants to hear that you've done your homework in generating the data it needs. This includes soundly created current financial statements, as well as projected balance sheets and future earnings statements. Some lenders look for as many as 36 months of cash forecasting, and a realistic financial contingency plan.

Should your licensing expire in any key area, the loan process will come to a screeching halt.

Your lender also wants to hear a realistic assessment of your own credit needs. Asking for an enormous line of credit without the backlog and sales projections to back it up doesn't put a construction business in the best light. Remember that, generally, lines of credit should be viewed as short-term cash flow boosters to aid operations while awaiting accounts receivable.

"I'm set up to succeed."

Every construction company needs to have certain foundational elements in place before contacting a lender. Most of these things you must have in place anyway, loan or not. But if they lapse or fall to suboptimal levels, your loan request may go unheard. In short, your lender wants to know you're set up to succeed.

For example, as obvious as it may seem, you need to have a good credit rating. Some contractors assume their credit is in fine shape, only to learn otherwise when seeking out a loan. Be sure to actively monitor and build your business credit on an ongoing basis.

There are also your licenses and permits. Should your licensing expire in any key area, the loan process will come to a screeching halt. Many lenders will also require you to pull all of your project permits. Doing so can be time-consuming, but missing permits will also hurt your chances of getting a loan.

Then there's insurance. Your lender wants to hear that you're covered for anything it considers pertinent. Be prepared to show proof of insurance in these areas, and be ready to discuss why you don't have a policy that a lender may believe is important. Last, don't forget about bonding. If you work on projects that require it, ask your surety to attest to your good financial standing.

"I know what I'm doing."

At the end of the day, lenders want assurance that you know what you're doing. This may sound simplistic, but these institutions really do look for contractors who know their industry and local markets, adhere to safe employment practices, and can complete projects on time. If you've been encountering difficulties obtaining a loan, work with your financial advisor to target areas of your business that may need improvement.

THE CONTRACTOR'S CORNER

Should I go "pro" with time and billing software?

I visited my attorney's office the other day. She was raving about all of the bells and whistles of her time and billing software. It got me thinking about my construction company's invoicing system, which is partly electronic but also still partly paper-based. Would it be worth my while to invest in this technology for my construction business?

Indeed, time and billing software is typically associated with professional services firms such as attorneys and accountants. But it also offers a number of potential benefits for contractors. You've just got to know what you really need before spending hard dollars on a solution.

Gathering data

True to its name, time and billing software records the *time* an employee spends on a given activity and then *bills* the appropriate amount to an invoice. In doing so, it can allow you to track workers' hours and very specifically align expenses with projects and clients.

Many applications also enable you to run billing cycle reports that conveniently display information such as:

- Hours worked,
- Costs incurred,
- Hours and dollars billed, and
- Dollars remaining owed.

What's more, most of today's better time and billing software will integrate with your construction company's existing payroll and accounting systems. So you can use the data generated by employees to cut paychecks, as well as fulfill your payroll and income tax obligations.

Reaping the benefits

There's little doubt these applications offer contractors a variety of potential benefits. The right solution should save you time in tracking workers' hours, and it should reduce inaccuracies that can occur from manual systems or even less sophisticated electronic ones. Plus, many of today's products are cloud-based, so employees can log hours and job info right from their smartphones or from an on-site laptop.

A well-chosen system could also speed up your accounts receivable. Because everything is automated, you can invoice clients — and hopefully receive their payments — more quickly. Some software even enables you to set up an e-commerce function, whereby clients submit payments via a merchant gateway (such as PayPal).

Naturally, there are risks to too hastily procuring any software. Free or low-cost solutions may provide relatively little functionality and not integrate with your wider systems. Meanwhile, high-end systems may be prohibitively expensive, difficult to implement and too complex for smaller construction companies.

Shopping wisely

Time and billing software is likely a good idea for your construction business — particularly if you're still partly relying on paper-based documentation. But you'll need to set a budget, shop carefully and buy only an application that you'll fully use.

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Analyzing and Managing Cash Flow

Maintaining strong cash flow can be critical – and challenging – for contractors, subcontractors, and construction companies. The majority of cash inflow comes from projects currently underway, which involve covering spending for project completion while relying on customer payments to cover payroll, vendor expenses, and other business expenses.

Many construction companies don't realize their cash flow balance is misaligned until it's too late. Monthly balance sheets or income reports may not provide advance warning of a problem.

How to assess the strength of cash flow

While cash flow can be defined as the amount of payments received minus payments made over a set period, maintaining a healthy cash flow involves more complex calculations. Analyzing cash flow involves several key indicators. These may include:

- Working capital percentage (funds available after debts and expenses are settled)
- Liquidity and the company's ability to meet financial obligations
- Cash demand and ratios such as working capital turnover and the average number of days to settle outstanding accounts

Why cash flow is important

In addition to allowing a business to cover its expenses, cash flow management can impact the relationship a company or contractor has with sureties or other lenders.

Borrowing funds is often necessary because purchasing and labor frequently precede customer payments. Equally important, lenders will analyze a borrower's ability to maintain sound financial practices and a healthy cash flow.

A surety underwriter will examine several factors when deciding if a borrower is a strong candidate for a loan or bond such as:

- Debt-to-equity ratio
- Timely bill payments
- Accurate in-house financial tracking
- Existing borrowing or overbilling

Best practices for cash flow management

There are several ways to strengthen cash flow:

- Setting up progress payments with a schedule of values
- Setting up a standardized billing and collection policy
- Negotiating better contract terms
- Factoring some portion of accounts receivable

The LaPorte Construction Industry Group has more than five decades of experience providing accounting services to the industry. For more information on establishing practices to strengthen cash flow and enhance financial flexibility, contact Directors Tracy Tufts at ttufts@laporte.com or Frank Sharp at fsharp@laporte.com.