Deconstructing the Income Statement

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Provided to company management, financial institutions, sureties and customers alike, financial statements are the main source of a contractor's historical performance. This historical data is used to analyze the contractor's business when determining lines of credit, loans and surety bonds—or even when deciding whether to allow a contractor to perform work.

Most interested parties will focus on the contractor's balance sheet without much regard for the income statement. Generally, they will home in on revenue, gross profit and net income.

However, a prudent examination of the income statement provides crucial fiscal information about the company's history and performance that must also be factored into evaluating its strength and stability.

The major components of an income statement are:

- Revenue Earned
- Cost of Revenue Earned
- Selling, General and Administrative Expense

Revenue Earned

Not all revenue earned is equal. Revenue can derive from contracts with different types of profit structures, such as lump sum, fixed price, unit price, cost-plus-a-fee, cost-plus-a-fee-with-a-guaranteed-maximum or time and materials. While these are all considered "revenue earned," each requires a distinct analysis to understand how a contractor is truly performing.

Most contractors calculate revenue utilizing the percentage of completion method, which is based on estimates. For all contracts in progress at the financial statement date, revenue is based on the actual cost incurred during the year, plus gross profit realized during the year.

The gross profit realized is determined using the estimated completion percentage of the project. This is determined by calculating the actual cost incurred as a percentage of the estimated total cost to complete the project. If a contractor's estimated costs are wrong, the reported revenue earned and gross profit will also be incorrect.

To understand the risk related to the accuracy of the financial statement, it must be made clear how much of the revenue is based on estimates. The more revenue based on estimates, the higher the chance of the revenue being over- or understated. The income statement should illustrate the cost of each type of revenue

earned to demonstrate where the company's profit is truly originating.

Cost of Revenue Earned

Cost of revenue earned is calculated to determine a contractor's gross profit. This formula requires a con-crete understanding of all factors included in the cost of revenues earned.

Revenues earned consists of both direct and indirect costs. The definition of a direct cost is any cost that can be directly associated with the project. Examples of direct costs include direct labor (labor on the jobsite), materials purchased specifically for the project, subcon-tractors, equipment to install on the project, etc.

Indirect costs are items not directly related to the performance of the work, such as warehouse labor, depreciation on equipment, insurance, equipment repairs, union or other benefits to labor associated with the work on a project, etc. Indirect costs are often overlooked as a true cost on a project. Worse, they often are not charged to a project but instead are included in the selling, general and administrative (SG&A) section of the income statement.

Indirect costs are required to be allocated to a project based on a systematic approach correlated to direct labor hours, equipment hours, or a combination of both. If indirect costs are included in SG&A, the contractor is overstating its actual gross profit as well as overstating SG&A. This will have a significant impact on the health and accuracy of the financial statements.

Indirect project costs can change over time. A con-tractor should, at least annually, analyze indirect costs and the methodology used to allocate those costs. This will determine if indirect costs are being accurately applied to contracts. If it is determined that indirect costs are being under- or over - applied, the frequency of analysis should be adjusted moving forward.

A contract bid should incorporate estimates of both direct and indirect costs. Incorrect estimates can have the unintended consequence of greater total project costs, resulting in lower gross profit, or even contracts finishing at a loss.

A characteristic sign of this is seen in recurring contract "fades." A contract fade results when a contractor reports a final gross profit lower than the estimated gross profit shown in previous reporting periods. Not knowing the true contract fulfillment

cost can result in a short life span for a construction company.

Contract schedules should accompany any income statement provided by the contractor. Without the contract schedules, it's impossible to understand how each project impacts the statement. In order to calculate the contract gain or fade, the current contract schedules need to be compared to prior periods in order to see the progression of the projects and understand any positive or negative impact on the project gross profit.

Cost of revenues earned is typically considered a variable cost. Variable costs will increase or decrease based on the contracts and volume of work performed by the contractor. By definition, variable costs are separate from SG&A costs, which are fixed costs.

Selling, General and Administrative (SG&A)

SG&A costs are associated with running the "back office" operations of a company. These include office staff, payroll, sales and estimating, utilities, general insurance, office expenses, etc. SG&A costs are incurred regardless of whether the contractor has booked current or future work. For the most part, SG&A costs are fixed, meaning they don't increase or decrease with revenue.

The most profitable contractors stringently focus on keeping the SG&A costs at a minimum. The reason for this is simple. SG&A is the amount of overhead that a contractor needs to cover from the gross profit earned on projects. The lower the SG&A, the less gross profit is required to cover these costs.

For example, say a contractor normally earns 10% gross profit on its projects and has SG&A of $1,100,000 annually. In order to break even after covering the cost of revenues earned and SG&A, the contractor would have to earn $11,000,000 in revenue the following year ($1,100,000 SG&A divided by 10% gross profit). If the contractor normally generates $15

million per year, $1.1 million seems like a reasonable SG&A based on that volume. But what if the contractor normally has revenue in the $9 million range? This would mean either the revenue must be increased by successfully obtaining new work through bidding, bid prices need to be increased or the SG&A needs to be reduced.

A frequent ratio considered by the users of financial statements compares a contractor's backlog and related gross profit with its typical SG&A costs. Using the same average SG&A of $1,100,000 and 10% gross profit, assume a contractor has $16,500,000 of backlog. This ratio would mean the contractor has 18 months of work under contract to cover its SG&A costs ($1,650,000 of gross profit divided by $1,100,000 of annual SG&A costs = 1.5 years or 18 months).

The users of the contractor's financial statement are calculating these ratios and making decisions about the contractor's business. It is imperative that the contractor also understand these ratios to ensure the business is portrayed in the strongest possible light.

When a contractor can understand the importance and characteristics of the income statement and what it is telling the intended user, it can be a very powerful tool. Most contractors "know their numbers," but the actual understanding of sources and types of revenue, as well as the different types of costs (direct, indirect and SG&A), can truly elevate a contractor from a financial reporting perspective and likely lead to more accurate reporting of gross profits.

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