



# MASTERING YOUR FINANCIAL HEALTH

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## WORKBOOK

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As a Contractor, you are an expert in your craft. You know what tools and materials are needed for the job you are working on, the measures to put in place to avoid injury, and how to pivot when deadlines are inevitably moved. These are extremely important aspects of every Contractor's business.

Have you stopped and thought that mastering your financial health is every bit as important?

For your construction business to be truly successful and grow, you must have a clear picture of your finances. Let's investigate some financial terms and why they are so important to your business.

## Understanding Financial Statements

Financial statements report the condition of a construction company and serve as a basic measurement of the company's strength or weakness. To Creditors, like Banks and Sureties, these statements are an essential underwriting tool when making decisions like bonding, that support the Contractor. The ability to read and understand these statements is an extremely valuable management tool.

Most of the key components that underwriters evaluate are contained within the balance sheet. This shows a company's financial position at a specific point in time. Typically, Surety companies and Credit facilities require financial statement reporting mid-year or at your year-end.

In this workbook, we will explain the importance of the following formulas:



Working Capital



Current Ratio



Return on Investment

Although there are other key financial ratios that assist in measuring your construction firm's financial health, mastering these 3 are a vital first step.

## Working Capital

The primary focal point when it comes to evaluating your Surety Bond Program is working capital. This is a measure of a company's liquidity, operational efficiency, and its short-term financial health. Significant positive working capital enables a company to invest and grow. However, if a company's current assets do not exceed its current liabilities, then it may have trouble growing or paying back Creditors, or even go bankrupt.

The formula used to determine your working capital is:

$$\text{Total Current Assets} - \text{Total Current Liabilities} = \text{Working Capital}$$

Here is an example of a Construction Company's balance sheet that we will refer to throughout this workbook.

### ASSETS

#### Current Assets:

Cash	\$	10,760,285
Contract Receivables		5,615,983
Underbilling		1,065,407
<b>Total Current Assets</b>	<b>\$</b>	<b>17,441,675</b>

#### Long Term Assets:

Equipment		1,729,599
Less Accumulated Depreciation		(921,582)
Net		808,017
	\$	18,249,692

### LIABILITIES AND STOCKHOLDERS' EQUITY

#### Current Liabilities:

Accounts Payable	\$	9,841,714
Note Payable Current Portion		500,000
Accruals		49,418
Overbillings		2,882,280
<b>Total Current Liabilities</b>	<b>\$</b>	<b>13,273,412</b>

#### Long Term Liabilities:

Note Payable net of current portion		1,067,298
<b>Total Liabilities</b>	<b>\$</b>	<b>14,340,710</b>

#### Stockholders' Equity:

Common Stock, no par value, 100,000 shares authorized, 1,000 issued and outstanding		96,000
Retained Earnings ending (Owner's Equity)		3,812,982
<b>Total Stockholders' Equity</b>	<b>\$</b>	<b>3,908,982</b>
	\$	18,249,692

Based on the information in our example balance sheet, the working capital formula is determined by:

$$\text{\$17,441,675} - \text{\$13,273,412} = \text{\$4,168,263}$$

Working capital translates to your Aggregate Surety Bond Program as a general rule of thumb of 10 times your working capital. However, there may be other underwriting variables, including personal net worth, evaluation of depreciated equipment, and type of Contractor (General Contractor vs Subcontractor) that may change or increase the evaluation of your Aggregate Bond Program.

While there are various financial ratios that are important, we will focus on one of the liquidity ratios, the current ratio.

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## Current Ratio

The current ratio is among the most frequently used financial measures for the typical Contractor. This ratio is used to determine the number of times current liabilities can be paid by current assets.

The formula to determine current ratio is:

$$\text{Total Current Assets} \div \text{Total Current Liabilities} = \text{Current Ratio}$$

Based on the information entered in our example balance sheet, the current ratio is determined by:

$$\text{\$17,441,675} \div \text{\$13,273,412} = \text{1.3 Ratio}$$

Generally, banks and bonding companies indicate that they use a 2.0 to 1.0 current ratio as the ideal standard. This standard means that a company would need to have, at a minimum, twice as much in current assets as their current liabilities. However, this standard is not entirely applicable to contracting since, by the very nature of the business, Contractors have considerably greater operating opportunities without having to maximize current assets.

Contractors normally have a relatively small portion of their total assets invested in material inventory, as compared to the relatively high portion needed in some other industries. A current ratio of 1.5 to 1.0 may be adequate for many Contractors. With a current ratio of less than 1.5 to 1.0, the company may have difficulty meeting current obligations. In other words, it may be undercapitalized or the company may have too much of its capital invested in fixed assets.

On the other hand, while a Contractor with a current ratio of more than 2.0 to 1.0 shows outstanding financial strength, they may have become inefficient and stagnant. When the current ratio approaches or exceeds 2.5 to 2.0, the company is likely overcapitalized. In such cases, management should consider investing the excess current assets in other profit-generating ventures or expanding its contracting business.



## Return on Investment

What is a 'good' return on investment for your construction firm? There is no one right answer to this question as it is dependent on what a Contractor expects for their business.

A Contractor should primarily be concerned with performance when determining what investment to make. Performance is the likely return the Contractor can expect when compared to the relative risk of loss to which the investment is exposed. Meaning, the less risk involved, the lower the return the Contractor should be willing to accept.

Conversely, for an investment of substantial risk, the Contractor should demand a substantially higher return. The customary measure of return on investment for the Contractor is Income Before Taxes (Profit) generated as a percent of the Total Retained Earnings (Owner's Equity).

Understanding this can help determine the appropriate compensation for the risk faced. The calculation used to capture this is the return on investment formula.

The return on investment (ROI) is:

$$\text{Income Before Taxes (Profit)} \div \text{Total Retained Earnings (Owner's Equity)} \times 100 = \text{Return on Investment}$$

Here is an example of the same Construction Company's income statement. We will refer to it for this section of the workbook.

### INCOME STATEMENT

Contract Revenues	\$	36,948,970
Contract Costs		33,746,123
Gross Profit		3,202,847
Operating Expenses		2,712,091
Income From Operations		490,756
Other Income		170,987
<b>Income Before Taxes (Profit)</b>	<b>\$</b>	<b>661,743</b>
Income Tax Expense		4,476
Net Income		657,267
Retained Earnings, beginning		3,354,404
Stockholder Distributions		(198,689)
<b>Retained Earnings, ending (Owner's Equity)</b>	<b>\$</b>	<b>3,812,982</b>

Based on the information entered in our example income statement, the ROI is determined by:

$$\frac{\$661,743}{\$3,815,982} \times 100 = 17\%$$

The number you receive as your ROI (which is a %), when converted to dollars, simply means that for each \$100 invested in the firm, the investor receives that dollar amount before taxes. As a result, you will be able to determine when you can recoup your total investment.

## Determining Your Financial Performance

When determining your company's financial health, it's important to review your previous year's performance. Here is a simplified blank Balance Sheet & Income Statement, that you can use to help find your financial numbers.

### Practice Simplified Balance Sheet

Current Assets:	
Cash	\$
Contract Receivables	
Underbillings	
<b>Total Current Assets</b>	<b>\$</b>

### LIABILITIES & STOCKHOLDERS' EQUITY

Current Liabilities:	
Accounts Payable	\$
Note Payable Current Portion	
Accruals	
Overbillings	
<b>Total Current Liabilities</b>	<b>\$</b>

Stockholders' Equity:	
Common Stock, no par value, 100K shares authorized, 1,000 issues & outstanding	\$
Retained Earnings (Owner's Equity)	
<b>Total Stockholders' Equity</b>	<b>\$</b>

### WORKING CAPITAL

Total Current Assets	
Total Current Liabilities	-
<b>Working Capital</b>	<b>\$</b>

### CURRENT RATIO

Total Current Assets	
Total Current Liabilities	÷
<b>Current Ratio</b>	<b>\$</b>

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## Practice Simplified Income Statement

Contract Revenue	\$
Contract Costs	
Gross Profit	

Operating Expenses	\$
Income From Operations	

Other Income	\$
<b>Income Before Taxes (Profit)</b>	<b>\$</b>

Other Income	\$
Net Income	

Retained Earnings, beginning	\$
Stockholder Distributions	
<b>Retained Earnings, ending (Owner's Equity)</b>	<b>\$</b>

### RETURN ON INVESTMENT (ROI)

Income Before Taxes (Profit)	
Retained Earnings, ending (Owner's Equity)	÷
<b>Return On Investment</b>	<b>%</b>

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# Financial Health Checklist

As you evaluate what your goals are for the future of your company, it's important to also keep in mind the following questions:

- What was last year's overall plan?

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- What were the results of last year's plan?

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- What worked?

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- What didn't work? .....

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- What type of work do you want to win?

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- Will you have any additional equipment needs?

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- What type of capital needs are you expecting (i.e. Labor, PM, or Special Skills)?

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Evaluating your past performance and future goals, really help determine what is working and what isn't. All of these factors contribute to your overall financial health. This is why it's important to keep good financial records. The better financial health your company is in, the easier it will be for you to meet your future goals.

If you have questions or concerns about your company's financial health or would like to have your company's financials evaluated, [reach out to TSIB's Risk Consultants today!](#)



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