**CES 421 M23**

**Assignment Week 2**

Is the managerial focus on financial ratios helpful or harmful to the long-term success of a construction business?

The financial ratios are based on known data points. The success of failure can be explained by forensic analysis when there is certainty of facts.

However, very seldom if ever, the future can be based on the past.

The Political, Economic, Social, Technological, Environmental, Legal/Regulatory environment are dynamic not static. They change.

Are the Financial Ratios useful in the environment of uncertainty?

Explain your rationale.

[Blog](https://billd.com/blog?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=Blog) | [Feed](https://billd.com/rss-feed/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=Feed) /

**Background reading:**

**Financial Ratios in Construction: Why Subs Should Be Familiar with Them**

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Financial ratios are key for anyone wanting a clear and simple view of the financial health of a construction business. They show how a company is performing in important areas such as liquidity, leverage, and financial efficiency. This can be hard to determine from standard financial statements – but financial ratios give a quick and accurate indication.

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What Are Financial Ratios and Why Are They Useful?

It is often difficult to determine the most important metrics and figures within the [financial statements](https://billd.com/blog/construction-accounting?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=financial-statements) of construction companies. Profit and loss statements, balance sheets, and other reports are useful and important but can be hard to interpret.

Financial Ratios are an alternative to this. They present a clear picture of current business performance in vital areas. They will show you the company’s current financial health and can also be used to quickly benchmark against other companies or sector averages.

Knowing the key ratios to look for is essential. There are many possible ratios of interest to different companies. For construction companies, a few stand out – including the Current Ratio, Quick Ratio, Debt-to-Equity Ratio, Working Capital Turnover Ratio, and Equity Turnover Ratio. We’ll explore these ratios below.



Ratio Categories You’ll Be Looking At

The information on a company’s balance sheet and accounts can be used to create any number of ratios. Indeed, some of these are very specific and niche. There is a common set, though, of very useful ratios for construction companies to understand.

**The ratios discussed above fall into 4 categories:**

* Liquidity ratios – These show the extent to which companies can meet their short-term commitments.
* Profitability ratios – They show a company’s ability to turn revenue into profit.
* Leverage ratios – These ratios show how a company finances its assets and operations – and the level of debt involved in this.
* Efficiency ratios – These provide a measure of how well a company uses its value to generate revenue.

Current Ratio

The Current Ratio is a liquidity ratio. It shows the company’s ability to use its assets to pay off its short-term debt. If all short-term liabilities suddenly became due, could the company cover these?

It is calculated by dividing the total current assets by the total current liabilities. The Current Ratio uses all current assets and all current liabilities in the calculation. It is also known as the Working Capital Ratio.

What’s considered a good ratio?

A current ratio above 1.0 is considered good for a construction company. This indicates that the company could pay off all its liabilities if they become immediately due. A ratio of less than 1.0 implies a high level of liabilities and could be a sign of upcoming financial problems.

Be careful with high ratios, though. Although a ratio higher than 1.0 is financially healthy, too high a ratio could indicate that the company is not using its [working capital](https://billd.com/blog/the-subcontractors-guide-to-working-capital/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=working-capital) as efficiently as it could. It may be missing opportunities to generate revenue through its assets – either through the business or through investment.

If you want to compare your company with the average, consider that the overall average Current Ratio amongst US-listed construction companies was 1.54 in 2020, and 1.65 in 2019.

Quick Ratio

The Quick Ratio is another liquidity ratio. As its name suggests, it looks at assets that can be liquidated quicker. It is also known as the Acid Test Ratio.

It is calculated in the same way as the Current Ratio, by dividing current assets by current liabilities. Only cash, cash equivalents, accounts receivables, and short-term investments are included as current assets for the Quick ratio. Other assets, such as inventory, are excluded as they would take longer to liquidate if needed.

What’s considered a good ratio?

Like the Current Ratio, the Quick Ratio again should be higher than 1.0 to indicate the ability to pay off all short-term debt. It will be lower than the Capital Ratio as only some current assets are considered. A level between 1.1 and 1.4 is generally deemed to be good.

The same comparison against all US-listed construction companies can be made. The average Quick Ratio was 1.01 in 2020 and 1.10 in 2019.

Debt-to-Equity Ratio

The Debt-to-Equity ratio is a leverage ratio. It measures the growth of a company that has [debt](https://billd.com/blog/construction-debt-strategies/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=debt) financing. Looking at a company’s level of debt on its own does not tell you much – you want to consider this alongside how well the company is growing.

It is calculated very simply by dividing company debt by total equity.

What’s considered a good ratio?

The higher the ratio, the more debt the company has. Anything above 1.0 is normal, but a ratio higher than 2.0 indicates that the company has taken on too much debt. High ratios will likely have an impact on the ability to access further loans or [lines of credit](https://billd.com/blog/contractor-lines-of-credit/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=lines-of-credit). The average amongst US-listed construction companies was 1.21 in 2020.

Working Capital Turnover Ratio

The Working Capital Turnover Ratio reflects how well a company is using its capital to support sales and company growth. In essence, it shows the amount of sales generated for every dollar of [working capital](https://billd.com/blog/the-subcontractors-guide-to-working-capital/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=working-capital) used. The Working Capital Turnover Ratio can be considered both a liquidity ratio and an efficiency ratio.

It is calculated by dividing total construction sales by working capital. A company’s working capital is determined as the difference between current assets and current liabilities.

What’s considered a good ratio?

A high ratio shows that the company is being efficient in using its assets and liabilities to support sales. A lower ratio indicates less efficiency. For example, a working capital ratio of 10.0 would imply that every dollar of working capital supports 10 dollars in sales.

This is a harder ratio to quantify levels for and is very company dependent. The higher the level, the better. However, the industry generally considers a ratio higher than 30 problematic. This could indicate that more working capital is needed to support continued growth.

Looking at overall rations for US companies (based on a 2020 CFMA study), shows a ratio of 6.8 for companies with under $50 million in annual revenue. For larger companies, it increases to 13.6.

Equity Turnover Ratio

The Equity Turnover Ratio is another leading efficiency ratio. Like the Working Capital Turnover Ratio, it also looks at how well the business Is using its value. However, this ratio considers the use of its equity rather than its capital. It is calculated by dividing total sales by total equity.

What’s considered a good ratio?

The Equity Turnover Ratio shows how well a construction company uses its current equity to drive revenue for the business. Like the Working Capital Turnover Ratio, a higher value indicates better use of equity.

With this ratio, in particular, it is important only to consider similar companies. A services company, for example, could have a much higher ratio than a more capital-intensive company. For the construction industry, ratios above around 15 could indicate future growth issues.

Key Considerations as You Evaluate Financial Ratios for Your Construction Business

Financial ratios are a great tool for assessing how well your business is performing. For a more complete understanding of a company’s position or success, you can study the full financial statements. Ratios, however, present the key data and are much simpler to understand and compare.

To get the most out of them, there are several important considerations:

**Ratios can be more meaningful than raw financials**. Financial statements provide point-in-time data such as cash balances, cash flows, and profit. Ratios can tell you more than this and are a better insight into company performance.

**No one ratio is the best**. No single ratio will explain everything about performance. Understanding what each ratio shows and which ones to consider together is important. For example, a company may have a strong Current Ratio, but its Debt-to-Equity ratio could show too much debt being taken on.

**Benchmark against other companies, but make sure they are comparable**. Comparing your ratios against those of other companies is an excellent way to gauge performance, and there are several [studies](https://ucsd.libguides.com/finance/industry_ratios) and [reports](https://www.mossadams.com/landingpages/construction-financial-analysis-report) that can help with this. However, some ratios can vary a lot between companies, so you want to ensure you compare with similar types of construction companies.

These financial ratios have many uses. They can help you to carry out financial planning, understand the likelihood of being offered credit or loans, and predict the future financial path for the company. By getting acquainted with these key financial vital signs, subs are putting themselves in a better position for [business growth](https://billd.com/blog/grow-construction-business/?itm_source=www.google.com/&itm_medium=Webform&itm_campaign=/blog/financial-ratios-construction/&itm_content=Desktop&itm_term=business-growth).

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