Survival Guide to Overbillings

By Walt Mathieson

Overbillings are a pervasive problem for many small contractors, particularly in the remodeling industry. When, in a period of slowing activity, billings to clients exceed the amount actually earned by the contractor, it can be especially troublesome, even lethal. It is like an 18-wheeler tailgating a small car on the highway – the car has to keep going fast or it will get crushed. The problem is worse when the driver of the car doesn't realize that the menacing truck is rushing up behind him.

Long ago, contractors recognized the benefits of getting ahead of their clients in the cash flow department. Because it is more advantageous to let the client fund their own construction activity, the contractor has traditionally tried to get ahead of the client with advance deposits, front-loaded draw schedules, and "payment upon receipt" terms. This is a great technique for funding a project – less expensive than using your own credit facilities, and it reduces the likelihood of a collection problem.

Problems arise when contractors fail to recognize the overbilling condition. Overbillings, or "billings in excess of costs and earnings" as the accountants call it, are a liability that must be recognized on a contractor's balance sheet before its financial statements can be truly meaningful and useful. Look at overbillings as money you might have to give back to the client if there was a work stoppage for any reason. Think of overbillings as revenues you have not yet earned and therefore don't really belong in the income statement yet.

If overbillings are not properly recognized and accounted for, a contractor may misinterpret their financial position. Thinking that profits and equity are high, the owner may want to take working capital out of the business for investment in new equipment, bonuses, dividends, or other profit distributions. In fact, the funds taken out of the company may be urgently needed later on to fund the completion of the work in progress.

What the Accountants Want

Generally accepted accounting principles suggest that construction contract revenue should be recognized proportionately to the costs incurred, rather than based on billings. Overbillings (and underbillings) should be calculated separately for each contract using the following formula:

$$((CTD / TEC) \times TER) - BTD = X$$

Where
CTD is Costs to Date
TEC is Total Expected Costs,
TER is Total Expected Revenue,
BTD is Billings to Date and
X is Overbillings (Negative) or Underbillings (Positive)

<u>Example:</u>
A $100,000 contract is expected to cost $60,000 and result in a 40% gross profit. Costs of $20,000 have been incurred to date. Revenue of $33,333 should be recognized to date:

($20,000/$60,000) x $100,000

If the contract terms permit the contractor to bill $45,000 by that same date, an overbilling of $11,667 should be recognized as a liability and not as revenue.

Overbillings can also cause problems for contractors that want to monitor their gross profit margins regularly. Profit margins will be abnormally high in the early stages of a job and abnormally low as the job winds down if steps are not taken to account for the overbilling conditions. Consider this example of a job that takes three accounting periods to complete:

Without Recognizing Overbillings

	Period 1		Period 2		Period 3	
Billings	$ 45,000	100%	$ 35,000	100%	$ 20,000	100%
Direct Costs	20,000	44%	20,000	57%	20,000	100%
Gross Profit	$ 25,000	56%	$ 15,000	43%	$ 0	0%

How can you monitor your gross profit percentages from period to period with reporting like this? Similarly misleading results are shown when billings lag behind recognizable revenues, causing an underbilling condition.

With Recognition of Overbillings

	Period 1		Period 2		Period 3	
Revenue	$ 33,333	100%	$ 33,333	100%	$ 33,333	100%
Direct Costs	20,000	60%	20,000	60%	20,000	60%
Gross Profit	$ 13,333	40%	$ 13,333	40%	$ 13,333	40%

Recognizing overbillings (or underbillings) results in a more accurate assessment of profitability over the life of the contract. Monitoring gross profit percentages is much more accurate and permits management to recognize a true decline in profit margins and respond more timely.

The 18-Wheeler

Many contractors have been able to ignore overbilling conditions during times of steady or increasing activities. When the going is good, new job starts help fund the completion of jobs that are winding down. Sure, its like robbing Peter to pay Paul, but it works. In addition, the gross profit margin monitoring during times of steady or increasing activity gets blurred, because there is always a mix of new jobs (with high ratios of billings to costs) and old jobs (with low billings to costs ratios) to smooth out the reported profit margin percentages. This is like driving the beltway at a consistently high speed, staying ahead of that big truck.

The crisis arrives when things slow down quickly. When the volume of work slows down, the pent-up liability for overbillings comes due, with contractors struggling to find the funds to complete projects whose billing stream has dried up. If the funds to complete projects are not available, the very existence of your business may be in jeopardy. It's like that 18-wheeler smashing into the back of your car…

How Can You Prevent Such a Tragedy?

We can keep running down the road as fast as we can and hope that we don't have to slow down, but sometimes it is not a situation that can be controlled or prevented. Clients have changes in circumstances, the economy slows down, important members of the company can become unavailable for long periods – these can all cause a sudden slowdown. Don't bet your company's future on the ability to stay ahead of that big truck running behind it.

Instead, honestly evaluate your overbillings on a regular basis. Record the liability on your financial statements and know what the real situation is. Monitor your gross profit margins regularly and know that you are really making the gross profit you need to sustain your company. Set aside working capital (in a money market fund or other safe investment) to cover the overbilling liability, so that if there is a sudden slowdown, funds will be available to finish the work and help the company live to fight again. Recognize that there is a big truck running behind you and find ways to keep an appropriate cushion between your rear and its grill.

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About the Author
Walt Mathieson is President of Mathieson Consulting, LLC, a business systems advisor to the construction, homebuilding and service industries. Mr. Mathieson is a Certified Public Accountant with over 30 years of experience in both public accounting and private industry. In addition he is an Intuit® Certified Master Builder™ ProAdvisor, providing implementation, training and financial consulting support to users of Intuit Master Builder, the industry leading full-featured business management package for contractors, homebuilders and developers. Mr. Mathieson is a member of the American Institute of Certified Public Accountants, the Greater Washington DC Society of Certified Public Accountants, the Construction Financial Management Association and the National Association of the Remodeling Industry.