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Financial Statements for the Construction Industry

Understanding the Requirements
What are Key Benchmarks



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Levels of Financial Statements

- Internally prepared
- Prepared by a Certified Public Accounting Firm
 - Compiled Financial Statement
 - Reviewed Financial Statement
 - Audited Financial Statement



Key Components of Financial Statements

- Balance Sheet – Assets, Liabilities & Equity
- Income Statement – Revenues & Expenses
- Statement of Retained Earnings – Reconciles Retained Earnings from prior to current year
- Statement of Cash Flow – Where did cash come from and where did it go?
- Notes to the Financial Statements & Schedules – The rest of the story!

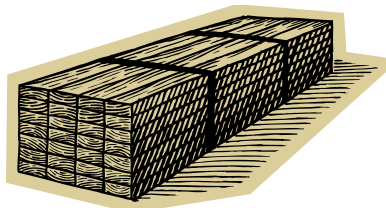
Balance Sheet

- Is a “snapshot in time” – presents the financial picture of the Company as of a specific date
- $\text{Assets} = \text{Liabilities} + \text{Equity}$



Assets

- Assets are everything you own (cash, inventory, investments, property & equipment) or have a right to receive in the future (accounts & notes receivables)
- Assets are presented on the balance sheet in order of liquidity (how fast can it be converted to cash)



Current Assets

- Cash
- Accounts Receivable
- Costs & estimated earnings in excess of billings on uncompleted contracts (Work in Progress)
- Other Current Assets



Property & Equipment

- Land
- Building
- Vehicles
- Construction Equipment
- Office Furniture & Equipment
- Leasehold Improvements



Other Assets

- Loan Acquisition Costs
- Cash Surrender Value of Life Insurance
- Deposits

Liabilities

- Liabilities are obligations of the Company to others, such as money owed to vendors, lenders or employees
- Presented on balance sheet in two primary categories
 - Current Liabilities
 - Long-term Liabilities
- Current liabilities are due within one year of the balance sheet date

Current Liabilities

- Trade Accounts Payable
- Line of Credit
- Customer Deposits/Construction Draws
- Billings in excess of costs and estimated earnings on uncompleted contracts
- Payroll taxes withheld and accrued



Current Liabilities

- Accrued Wages
- Accrued Taxes & Other Expenses
- Accrued Losses on Contracts in Progress
- Notes Payable - Shareholders

Long-Term Liabilities

- Notes Payable – Bank
- Notes Payable – Shareholder
- Notes Payable – Related Party



Shareholders' or Members' Equity

- Shareholders' (Corporation) or Members' (LLC) Equity is what remains after deducting total liabilities from total assets. This is the book value of the company to the owners
- Consists of:
 - Capital Stock or Members' Capital
 - Retained Earnings
 - Treasury Stock (in certain cases)

Items to avoid on Balance Sheet

- These are the things that you do not want to see on your balance sheet (nor does your banker or surety agent!) ☹
 - Cash Overdrafts
 - Loans to Officers
 - Loans to Employees
 - Current Liabilities > Current Assets
 - Negative Equity



Income Statement

- Provides information on the profitability of a company over a specified period of time, generally one year.

Income Statement

- Contract Revenue
- Cost of Contract Revenue



- Gross Profit

- Selling, General & Administrative Expenses
- Operating Income

Income Statement

- Other Income
 - Interest Income
 - Interest Expense
- Income before taxes
- Taxes
- Net Income
- **Net Income Does Not Equal Cash**

Statement of Cash Flows

- Provides information on the sources & uses of cash over a specified period of time, generally a year
- Where did the  come from and where did the  go?
- Reconciles accrual basis financials to cash basis by focusing on operating, investing & financing activities.

Cash Flows from Operating Activities

- Cash inflows & outflows from routine activities of the Company
 - Payments from customers
 - Disbursements to vendors & suppliers
 - Payments made to employees for salaries & wages

Cash Flows from Investing Activities

- Cash inflows & outflows from the Company's productive assets such as:
 - Property
 - Equipment
 - Investments
- Includes transactions such as:
 - Payments made to purchase above items
 - Gross proceeds form sale of above items

Cash Flows from Financing Activities

- Borrowing money
- Repayment of principal amounts borrowed
- Issuing stock
- Purchasing stock & paying dividends
- Distributions to owners

Non-Cash Transactions

- Additional non-cash transactions are also shown as reconciling items
 - Depreciation & Amortization
 - Gains & Losses on sale of Equipment & Property
 - Purchase of Property & Equipment by issuing Notes Payable or entering Capital Lease Obligations

Notes to the Financial Statements

- Summary of significant accounting policies
 - Business Activity
 - Use of estimates
 - Cash Equivalents
 - Methods of accounting used

Notes to the Financial Statements

- Accounts receivable (and doubtful accounts!)
- Concentration of risks
- Income taxes
- Costs & Estimated Earnings on uncompleted contracts
- Line of credit
- Long term Notes Payable

Notes to the Financial Statements

- Retirement Plans
- Backlog
- Lease Commitments
- Related Party Transactions
- Commitments & Contingencies
- Other information

Supplemental Schedules

- Schedule of Contract Revenue
- Schedule of General & Administrative Expenses
- Schedule of Completed Contracts
- Schedule of Contracts in Progress

Key Benchmarks

- Benchmarks are used to compare your company to others in the industry (aka Key Performance Indicator or KPI)
- Also used to compare trends for your company
- Ratios
 - <http://www.360financialliteracy.org/Tools/Calculators/Financial-Ratios>
- Analysis of Financials, Notes & Schedules
- Other Benchmarks

Liquidity Ratios

- Number of Days Cash
 - $\text{Cash} \times 360 / \text{Annual Revenue}$
 - Result should be seven days or more
- Current Ratio
 - Current Assets divided by Current Liabilities
 - Current Ratio should be greater than 1.25 to 1.0

Liquidity Ratios

- Accounts Payable Turnover
 - Cost of contract revenue divided by average accounts payable
- Age of Accounts Payable
 - 360 days divided by Accounts Payable Turnover
 - Age of Accounts Payable should be 45 days or less

Leveraged Ratios

- Debt to Equity
 - Total Liabilities divided by Equity
 - Should not be greater than 3 to 1
 - Current market conditions & specific trades may have more stringent requirements than this
- Long-term Debt to Equity

Profitability Ratios

- Gross Profit to Sales
 - Gross Profit divided by annual revenue
- Net Profit before Taxes divided by Annual Revenue
- Return on Assets
 - Net Income before taxes divided by Total Assets

Analysis of Balance Sheet

- Proper Classification – Current & Long-term Assets & Liabilities
- Analysis of Costs & Estimated Earnings in Excess of Billings on Uncompleted Contracts
 - Indicates the Company's ability to properly & timely get bills out (Job Costing efficiency!)
- Overbillings
 - If large, Company may be using current jobs funds to pay old liabilities
 - Will lead to cash flow problems down the road

Analysis of Income Statement

- Compared Year to Year
- Compare Revenue from one year to next
- Compare Cost of Revenue as a percentage (Gross Profit percentage)
- Compare Overhead as a percentage as well as a percentage to sales increase
- Increases in Expenses – based on percentage of Revenue

Statement of Cash Flows

- Analyze to see if Company has the ability to pay bills in a timely fashion
 - Trade Vendors
 - Payroll
 - Subcontractors
 - Debt Payment

Schedules

- Schedule of Cost of Contract Revenue (may be presented on the face of the Income Statement)
- Breakdown of:
 - Labor
 - Materials
 - Subcontractors
- Analysis done to compare work subbed out versus self performed

Schedules

- Schedules of Contracts in Process and Completed Contracts are a must for banks and Surety/Bonding
- Schedule of Contracts in Process
 - Number of Jobs
 - Size of Jobs
 - Gross Profit by Job

Schedules

- Schedule of Completed Contracts
 - Ability to Estimate
 - Compare gross profit from prior year or period to gross profit on contracts in process
 - Indicator of Contract Fade (where gross profit declines)

Other Items Analyzed

- Excessive Overhead Expenses
- Collectability of Accounts Receivable
- Proper Payment of Accounts Payable
- Balance to bill on contracts in process minus the estimated cost to complete equals available gross profit
 - Compare to operating costs for next year
- Backlog – like to see enough to produce gross profit \$ to cover 12 months overhead

Other (Non-Financial) Benchmarks

- Client Satisfaction
- Bids to Accepted Bids
- Defects
- Actual construction time compared to estimated time
- Employee turnover
- Safety
- Waste

What does all of this mean?

- Accurate & Complete
 - Financial Statements on Accrual GAAP basis
 - Complete Notes & Schedules
- Benchmarking
 - Internally (Company Trends)
 - Industry
- Management Review & Knowledge
 - Allow for better decision making & results!