Financial Statements for the Construction Industry

Understanding the Requirements

What are Key Benchmarks
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

• Assets = Liabilities + 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**
  – Cash x 360 / 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!