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# 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!

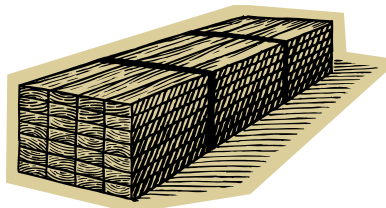
# Balance Sheet

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



# 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 from 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!