Understanding Homebuilders Financial Statements

2013 NAHB International Builders Show
Las Vegas, NV
January 22, 2013
A “snapshot in time.” The balance sheet presents the financial picture of the Company as of a specific date.

Assets = Liabilities + Equity or; stated another way, what you own (assets) = what you owe (liabilities) + value to owners (equity)
Assets are everything you own (cash, inventory, investments, property and equipment) or have a right to receive in the future (accounts and notes receivables)

Assets are presented on the balance sheet in order of liquidity (how easily the asset can be converted to cash)
CURRENT ASSETS

- Cash
- Accounts receivable
- Speculative homes under construction
- Residential lots held for sale or speculative construction
- Land held for development
- Land and Land development costs
- Developed Lots
- Costs and estimated earnings in excess of billings on uncompleted contracts (under billings)
### CURRENT ASSETS

- Finished Units (spec homes)
- Other current assets
PROPERTY AND EQUIPMENT

- Land
- Building
- Vehicles
- Construction Equipment
- Office Furniture
- Leasehold improvements
OTHER ASSETS

- Loan acquisition cost
- Cash surrender value of life insurance
- Deposits
Liabilities are obligations of the Company to others such as money owed to vendors, lenders or employees.

Liabilities are presented on the balance sheet in two primary categories:
- Current liabilities
- Long-term liabilities

Current liabilities are those obligations, which are due within one year from the balance sheet date.
CURRENT LIABILITIES

- Accounts payable - trade
- Line of credit
- Customer Deposits / Construction Draws
- Billings in excess of costs and estimated earnings on uncompleted contracts
- Development and construction loans payable
- Payroll taxes withheld and accrued
CURRENT LIABILITIES

- Accrued wages
- Accrued taxes
- Accrued expenses
CURRENT LIABILITIES

- Accrued losses on contracts in process
- Notes payable - Shareholders
LONG TERM LIABILITIES

- Notes payable – Bank
- Notes payable – Shareholder
- Notes payable – Related Party
Shareholder’s (S-Corporation) or Member’s (LLC) Equity is what remains after you deduct total liabilities (what you owe) from total assets (what you own). Stated another way shareholder’s/member’s equity is the value of the Company to its owners.
SHAREHOLDER’S or MEMBER’S EQUITY

- Capital Stock or member’s capital
- Retained Earnings
- Treasury Stock
Items you do not want on your balance sheet include:

- Cash overdraft
- Loans to officers
- Loans to employees
- Current liabilities in excess of current assets
- Negative equity
The income statement provides information on the profitability of a Company over a specified period of time, generally one year.

Contract Revenue – Cost of Contract Revenue = Gross Profit – Selling, General and Administrative Expenses = Net Income
INCOME STATEMENT

- Contract revenue
- Cost of contract revenue
- Gross profit
- Selling, general and administrative expenses
INCOME STATEMENT

- Operating income
- Other income
  - Interest income
  - Interest expense
- Gain (Loss) on sale of property and equipment
Income before taxes

Taxes

Net Income

Net Income Does Not Equal Cash
The statement of cash flows provides information on the sources and uses of cash over a specified period of time, generally one year.
The statement of cash flows reconciles the Company’s accrual basis financial statements (balance sheet and income statement) to the cash basis focusing on three major business activities including operating, investing and financing.
Cash flows from operating activities are:

Cash inflows and outflows from routine activities of the Company

Cash flows from operating activities include:

- Payments received from customers
- Disbursements to vendors and suppliers
- Payments made to employees for salaries and wages, etc.
Cash flows from investing activities are:

Cash inflows and outflows from the Company’s productive assets such as:

- Property
- Equipment
- Investments
Cash flows from investing activities include:

- Payments made to purchase property and equipment
- Gross proceeds from sales of property and equipment
STATEMENT OF CASH FLOWS

Cash flows from financing activities are:

- Borrowing money
- Repayment of principal amounts borrowed
- Issuing stock
- Purchasing stock and paying dividends
- Distributions to owners
Non-cash transactions are activities, which do not provide cash inflows or outflows and are shown on the statement of cash flows as reconciling items.

- Depreciation and amortization
- Gains and losses on the sale of property and equipment
- Purchase of property and equipment by issuing notes payable or entering into a capital lease obligation
NOTES TO THE FINANCIAL STATEMENTS

- Summary of significant accounting policies
  - Business activity
  - Use of estimates
  - Cash equivalents
  - Method of accounting for speculative homes and contract homes
- Accounts receivable
- Concentration of credit risk
- Income taxes
Costs and estimated earnings on uncompleted contracts

Line of credit

Long term notes payable

Retirement plans
NOTES TO THE FINANCIAL STATEMENTS

- Lease commitments
- Related party transactions
- Commitments and contingencies
SUPPLEMENTAL SCHEDULES

- Schedule of cost of contract revenue
- Schedule of general and administrative expenses
- Schedule of completed contracts
- Schedule of contracts in process
Liquidity Ratios

Number of Days Cash

Cash times 360 divided by annual revenue

Number of day’s cash should be seven (7) days or more
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
Current Ratio

Current assets divided by current liabilities

Current ratio must be greater than 1.25 to 1.0
Leveraged Ratios

Debt to Equity Ratio

Total liabilities divided by equity

Debt to equity not greater than 3 to 1

In today’s market getting tighter than that
Long-Term Debt to Equity

Long-term debt divided by equity
Profitability Ratios

- Gross Profit to Sales
  - Gross profit divided by annual revenue

- NPBT
  - Net profit before taxes divided by annual revenue
Return on Assets

Net income before taxes divided by total assets
Current assets should be assets collectible in the operating cycle

Accounts receivable not collected within one year should be classified as other assets

Analysis of costs and estimated earnings in excess of billings on uncompleted contracts

A function of the Company’s ability to properly and timely get bills out
Current liabilities should be any liabilities due within twelve (12) months

Long term liabilities are payments due after one year
LIABILITIES

- Over billings

- If this number is large, is the Builder using funds from current jobs to pay off old liabilities

- Will lead to cash flow problems down the road
Format should be correct

Titles should also be correct
GROSS PROFIT ANALYSIS

- Income Statement is compared Year to Year
- Comparison of revenue from one year to the next year
  - Also compared to gross profit percentage
- Overhead analyzed as a percentage and also analyzed as a percentage to sales increase
Analyze to see if the Company has the ability to pay bills in a timely fashion

- Trade vendors
- Payroll
- Subcontractors
- Debt payment
Schedule of cost of contract revenue

Breakdown of:

- Labor
- Materials
- Subcontractors

Analysis done to compare work subbed out versus self performed
SUPPLEMENTAL SCHEDULES

- Schedule of general and administrative expense
  - Increase in general and administrative expenses from one year to the next
    - Increase in all general and administrative expenses
    - Increase in certain items due to tax planning
      - Bonuses
      - Retirement Plan Contribution
Schedule of contracts in process and completed contracts is a must for banks

Schedule of Contracts in Process

- Number of jobs
- Size of jobs
- Gross profit by job
Supplemental Schedules

- Schedule of Completed Contracts
  - Ability to estimate
  - Compare gross profit from prior year or period to gross profit on contracts in process
- Schedule of Completed Contracts
  - Contract fade (decline in gross profit)
Income earned on contracts in process schedule and income earned on completed contract schedule must equal contract revenue on income statement.

Costs on contracts in process schedule and costs on completed contract schedule must equal costs of contract revenue on income statement.
Banks
OTHER ITEMS ANALYZED BY THIRD PARTY

- Excessive overhead expenses
- Collectability of accounts receivable
- Proper payment of accounts payable
Balance to bill on the contracts in process schedule minus the estimated cost to complete which gives available gross profit

Compare to operating costs for the next year

Third parties like to see backlog that will produce enough gross profit dollars to cover overhead for the next twelve (12) months
THANK YOU!

Questions?