

Review Financial Statements--Diagnostic Checklist

Below is a checklist of items that we review on a member's financial statements to tell us whether the reports accurately "tell the company story" . . . or not. The answers to the questions that this checklist bring up will help us clarify the company's current situation and identify actions that will improve performance.

Use the information below to help you identify possible issues. As you are reviewing the sample Company Focus packets, circle those items on which you have questions . . . or jot down your questions on a separate piece of paper. Time to get started!

Review Balance Sheet

- No negatives should appear, except for depreciation and Owner's Draws.
 - If there are other negative numbers, there may be a problem with data input.
- Current Ratio
 - Do they have enough cash on hand? They should have approximately 10% of annual volume available, unless planning to grow, at which time they may be spending a bit more.
 - Use Current Ratio to determine: $\text{Current Assets}/\text{Current Liabilities} = \text{Current Ratio}$.
 - Goal: 1.5:1 to 2:1 This means that they should have \$1.50 to \$2.00 of current assets for every dollar of current liabilities.
 - Use [Growth Sustainability Calculator](#) as a tool to see if there is enough cash for significant growth.
- Accounts Receivable
 - Does this seem reasonable for revenue?
 - Goal: 10% of revenue or less is best.
 - If the amount of money listed in Accounts Receivable looks high, ask why. Does AR represent only recent projects, or is a portion of the money represented non-collectible, such as from a dissatisfied client who will not pay. Is it very old? Typically, invoices that are more than 90 days old are very difficult to collect.
 - In other words, how much of the A/R do they really expect to collect?
- Assets
 - Current Assets – These numbers should represent items that are cash and any other company asset that will be turning to cash within one year from the date of the balance sheet.
 - Does this section include a line item for **Unbilled Revenue**?
 - This is an indicator that the company is using the Percentage of Completion Accounting method – the Gold Standard for remodelers.
- Long Term Assets
 - Is Depreciation being accounted for?
- Liabilities
 - Accounts Payable – Does this seem reasonable for the level of revenue and the level of cash on hand? If Accounts Payable are high, it is an indication that the company may not make enough money to pay their bills.

- Current Liabilities should include
 - Any monies that are to be paid out over the next 12 months – e.g. the next twelve months of Vehicle Loans.
 - ALL Lines of Credit, as they can technically be called at any time.
 - Does this section include a line item for **Unearned Revenue**?
 - This is an indicator that the company is using the Percentage of Completion Accounting method.
- Long Term Liabilities
 - Payments due more than 12 months out. Sometimes money loaned to the company by the owner will be put in here. Verify that it will be repaid, if not, recommend using a Journal Entry to move this amount to Retained Earnings.
- Equity
 - Distributions or Draws are shown as a negative number on the Balance Sheet. Check to see how much the owner takes out in Draws. Does the amount seem in line with the amount of revenue and profits generated by the company?
 - Verify that this number is for the current year. If it includes prior years, that portion should be moved into Retained Earnings.
 - If the owner is taking a draw, recommend moving the current year's draw from the balance sheet to the Overhead portion of the P & L. Then, the net profit will be accurate for the time period.
- Retained Earnings
 - Retained earnings are the profits that a company has earned to date, less any dividends or other distributions paid to the owner. A large retained earnings balance implies a financially healthy organization.
 - Negative retained earnings (actually called Accumulated Deficit) indicates that the company has lost more money than it has earned.
 - When evaluating the amount of retained earnings that a company has on its balance sheet, consider the following points:
 - *Age of the company.* An older company will have had more time in which to compile more retained earnings.
 - *Profitability.* A high profit percentage eventually yields a large amount of retained earnings.

Review Profit and Loss Statement

- Look for % of Income column. This should be the far right column. Reviewing percentages is a much easier, faster way to see if performance is on target.
- Check revenue. Does it look as though the company is on target to achieve their revenue goals? Find out by Annualizing the Revenue. For example, if you are looking at a P & L through the month of June, it shows 6 months of revenue. To see if they are on target, divide this number by 6 and then multiply by 12, the months in a year. If they are on target or beating revenue targets, great. If not, it is time to create an action plan for increasing revenue production for the second half or for cutting overhead to allow for a profit to remain.
- Are Cost of Goods Sold items sorted correctly? This category should at least include:
 - Materials

- Trade Contractors
- Labor
- Labor Burden
- Check Overhead for items that should be in COGS – Phone, Vehicle, Small Tools, Insurance, Workers Comp, etc. that can be applied directly or indirectly to the production department of the company.
- What Gross Profit % does the company target when creating the sales price for a project?
 - Do they know?
 - If not, this tells you that this company owner needs to learn quite a bit more about how to make and manage money.
 - If not, ask them to describe how they develop a sales price for a project.
 - Help them determine their target GP.
 - Once you have determined the Gross Profit Margin goal, check to see if they are achieving the goal by looking at the Gross Profit Margin on the Profit and Loss Statement.
 - If the P & L shows that the company is hitting their Gross Profit Margin goals within 1-2%, then give them a high five!
 - If job costs are significantly higher or lower than goal
 - There may be problems with the way the financial data is being reported.
 - There could be significant problems with estimating.
 - The production department could be inefficient.
 - Or a combination of all three.
- What % of Income is being spent on Marketing?
 - Should be between 2% and 5% typically. If less than this, the company might be experience a dearth of leads. If more than this, the marketing plan may be inefficient.
- Is Owners Comp included in Overhead?
 - If not, where is it represented?
 - What percentage of revenue does this compensation represent?
 - Stretch Goal: Owners Compensation (Salary + Draws) + Net Profit = >20%
- Check current Net Profit.
 - Is it within the success range of 5-10%? If so, wonderful. More high fives.
 - If it's lower, go back to other sections of the Profit and Loss to uncover the reasons why.

Review Budget

- Does the budget show owner's pay at 10% or more?
- Does the budget show Net Profit of 10% or more?
- Does the budget show COGS goal of 70% or less?
- Does the budget show reasonable growth?

Review the WIP Worksheet

- Check to see if column 9 has been updated with the current estimate of costs to complete.
 - Hint: If the numbers in column 9 equal the numbers in column 8, chances are the costs to complete estimates are not being updated.
- In column 18, Percent Complete, make sure there are no percentages that are over 100%. (It's pretty hard to do more than 100% complete. . . but sometimes the numbers seem to indicate that.)
- Check that all jobs that are 100% Complete have been totally billed out to the client. (Column 21.)
- Additionally, check to make sure that column 3 (Current Contract Price) has been invoiced properly.
- Compare Total Gross Profit % to GP % on P&L – should be no more than 2% + or -
- Review Slippage column – should be within 2% either way.

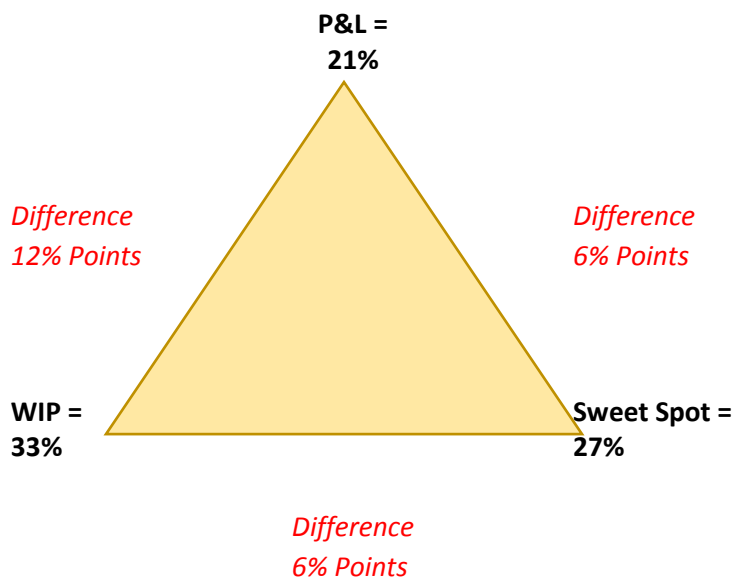
Golden Triangle

The Golden Triangle compares the gross profit from 3 different places on the focus packet: the profit/loss, the sweet spot report, the FINAL gross profit on the WIP (not including completed jobs*)

When the gross profit from these 3 data points are close (within 2% points plus or minus) it means job costs are included in COGS and not spread in overhead, that the job costs used in the WIP are correct and therefore the financial statements after the WIP adjustment are correct.

(*It is VITAL once a job is complete it be removed from the WIP and placed on the Completed Jobs tab of the annual WIP workbook. That way both the Sweet Spot and the WIP show the gross margin reflecting the individual job status.)

Example:



The previous example shows:

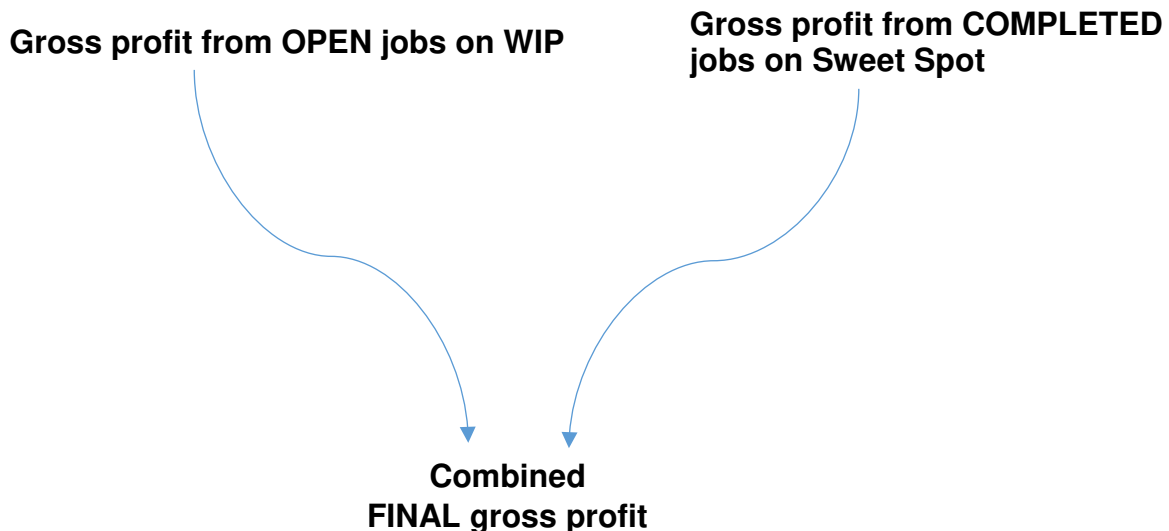
- There are costs in COGS not hitting the jobs - that's why the gross profit on the P&L is less than the other two
- Because jobs on the sweet spot are complete they show the gross margin from the current job cost method (which is missing 6% points of COGS)
- Gross margin is higher on the WIP because either (and/or) the company has raised prices, decreased slippage OR been optimistic re the estimated cost to complete – if they've done one at all. (These jobs are showing a 12%-point difference from the P&L.)

The P&L is the “source document” because it is the basis of managerial reporting and tax prep.

Gross profit on the P&L comes from two types of jobs:

1. Completed jobs which can no longer be manipulated; and
2. Open jobs on the WIP which can be manipulated through the estimated cost to complete.

Another view is:



Questions To Ask If The Numbers Are Off Target

- **Job Cost Questions**
 - Are job cost reports reviewed weekly or bi-weekly at a minimum?
 - Are budgets created and shared with the production staff in charge of the project?
 - Review a job cost report for usefulness.
 - In the summary report (cost codes collapsed to main headings), total actual costs as % of budget reflects SWAG estimate of job completion.

- **Estimating Questions**
 - Is there slippage? How much? (We feel that + or - 2% is acceptable.)
 - Why is there slippage? Is the issue with estimating or production?
 - Who does the estimating?
 - If salesperson does the estimating, how are you avoiding a potential conflict of interest – Keeping the price low in order to sell the job?
 - Does anyone review the estimate before the sale is closed?
 - Are client-driven changes documented with change orders each and every time?
 - Is money collected at the time?
 - Do they create change orders for internal revisions?
 - Are trade contractors providing firm prices for the estimate?
 - Are all cost categories on the P&L represented in the estimates?

- **Communication Process Questions**
 - Are they holding weekly or bi-weekly production meetings?
 - Are they holding weekly staff meetings for key managers?