



The Newsletter for Profit-minded Builders and Contractors

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Back to Basics: Controlling Construction Costs

by Paul Sharp and Bill Watkins

The profit a builder earns on each house he sells is dependent on two factors – the price that he is able to charge, and the costs he incurs in producing that house. The first factor is set by the market. It is a function of what potential buyers are willing to pay, and their ability to meet those payments. A builder may want to charge more, but unless someone in the market is willing to pay that price, he won't receive it.

The second factor (costs) is more under the control of the builder. While it's true that the builder has to pay the going rate for labor and materials, he should be able to determine what those costs are to a fairly certain degree, and to plan for those costs accordingly.

There are two aspects of controlling construction costs: pre-construction planning and construction management. The pre-construction process includes all the steps leading up to the day you break ground for the new house. It includes the definition of the product

Every month, review every job for excessive or unexpected costs. Use the variances to eliminate future costs. The time to find out you're over budget is not at the end of the job.

(plans and specifications), the establishment of the price (estimate and contract), and the creation of a good builder/client relationship. These items are among the most important contributors to profit.

During a period of escalating housing prices, builders have a tendency to get sloppy about controlling costs. After all, if the house costs more to build, the builder feels he can simply raise the price to cover those costs. But this leads to two unwanted consequences. The first is that any unnecessary costs directly

detracts from the potential profit. There may still be adequate profits due to price escalation, but they are less than they might have been.

The second unintended consequence is a loss of competitiveness. When the market turns down (which it inevitably will) the builder who can provide the best product for the best price will be the one with competitive advantage. In addition, a reputation for high prices can be difficult to overcome. The time to give your cost control systems a tuneup is now, when you have the time and resources, not when the market turns down and you're hurting for business.

Most custom builders work on a fixed-cost contract. They give the client a price for building their home, based on anticipated costs (their estimate or bid). If the bid doesn't cover all the builder's costs, every dollar over that budgeted amount comes directly from the builder's profits. From a profit point of view, if you fail in the pre-construction process you are doomed to failure even if you do a perfect job of construction. Great craftsmanship and a beautiful house are of little value to the builder if it's a money-losing project.



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Back to Basics

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Review and improve existing pre-construction systems

Before you can improve your cost control systems, you need to understand their weaknesses and failures. One of the best ways to do this is to compare past estimates with actual construction costs from several recently completed projects. Identify those areas where the greatest variations occurred. Is there any pattern to those variations? For example, you may find that your masonry or excavating estimates are consistently low. Try to understand why. Can you change your estimating procedures to eliminate this repetitive error?

If you are a portfolio builder, you want to evaluate the design of your spec homes. Are they value oriented, providing lost of features and amenities for the price charged? Are they up-to-date in their design, with lots of curb appeal and interior pizzazz? Simply by updating your design you may make a significant contribution to your perceived value.

Evaluation of non hard-cost factors

An estimating system needs to take into account more than simply the hard costs of materials and labor. The clients themselves can have a major impact of profitability. The hard part of estimating is the subjective evaluation of the client, the job and your need to win the bid. Here are some things to consider:

- Client personality and price consciousness.
- Location of site. Is it close to other jobs?
- Job complexity – are you getting in over your head? Do you have the expertise to do the job?
- Your availability/necessity for work, other workload, other potential contracts, general business environment.

If you determine that a particular client may be difficult to build for, you may decide not to build for that client, or you might want to add a factor into the estimate to compensate for the aggravation.

Estimating system design

Once you've evaluated your procedures, you might decide you want to change your entire estimating system. There are

many different estimating systems. They range from simple "Cost per square foot" methods to computer assisted estimating models. No matter which system is used, the same tasks need to be performed.

They are a measurement of quantities, calculation of costs by categories, summation of hard costs, addition of overhead and profit and summation of total costs. The actual system you use is less important than the fact that they are accurate and complete.

Upgrade estimating system

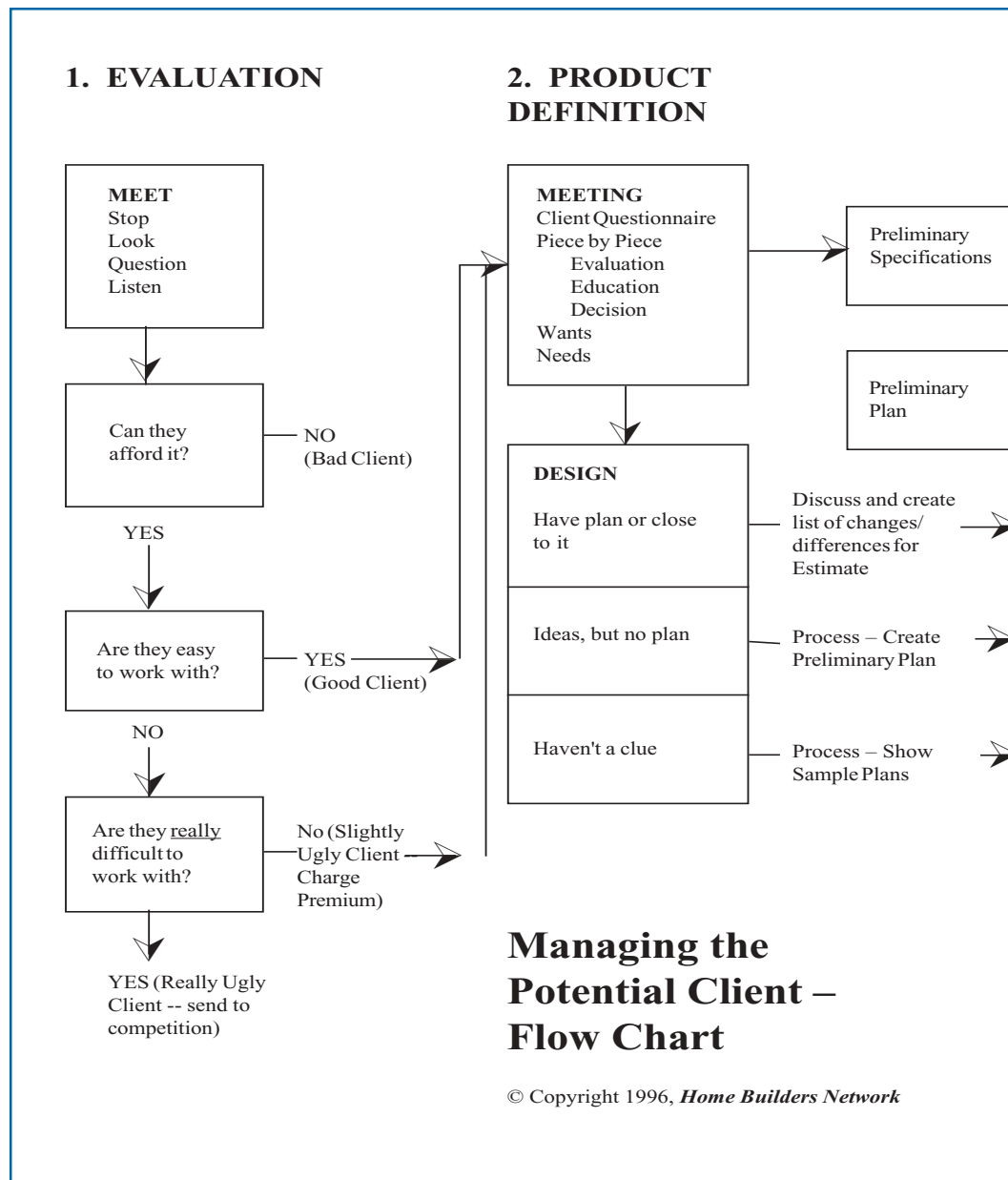
If you identified problem areas that affect your estimating accuracy, you need to fix them in a way that keeps them from cropping up again. While a computerized estimating program can be purchased for as little as \$500, the major expense is the

time and energy it takes to learn the system and adapt it to the way you do business. But if you catch just one major error, it pays for itself many times over.

Implement computer job-cost control system

Once you have a system you're comfortable with, and an estimating program that gives you accurate and timely numbers, the next step is to integrate this into a computer job cost control system.

Even if your pre-construction planning is perfectly executed, it's still possible to lose your shirt during actual construction. Most builders have a job-cost review process where ongoing costs are recorded and then compared on a monthly basis with the budgeted costs.



Managing the Potential Client – Flow Chart

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Here the trade-off is always functionality vs. complexity. Large scale integrated programs may be too difficult to implement, and actually lead to productivity decreases. If you use a simple accounting program, implementing the job cost control program is more straightforward, but doesn't add construction management functions such as scheduling. A job cost control system allows you to integrate pre-construction with construction management, get meaningful construction budgets, and identify cost overruns early in the process.

Managing construction costs

Once you've trimmed as much cost as possible through the pre-construction process, you need to begin managing the

ongoing construction costs. Most builders use a computerized job cost accounting program to keep track of costs by category. The critical point is to ensure that all costs are entered in a timely manner.

It's also important that all change orders be charged when ordered. Some builders require that the changes be paid for when ordered, others accumulate them and seek reimbursement at the time the construction draws are paid. The advantage of the second system is that there are fewer payments, the disadvantage is that some change orders may slip through the cracks.

If you're building production or spec houses the chief danger is that of creeping incremental expenses. A slightly nicer grade of cabinet, or better appliances for

example may only add a few hundred dollars here and there, but with the hundreds of selection decisions involved in building a house, the end result may be a home that is priced beyond the means of the targeted buyer. It requires constant vigilance to maintain the financial discipline necessary to bring the house in under budget.

Review costs monthly

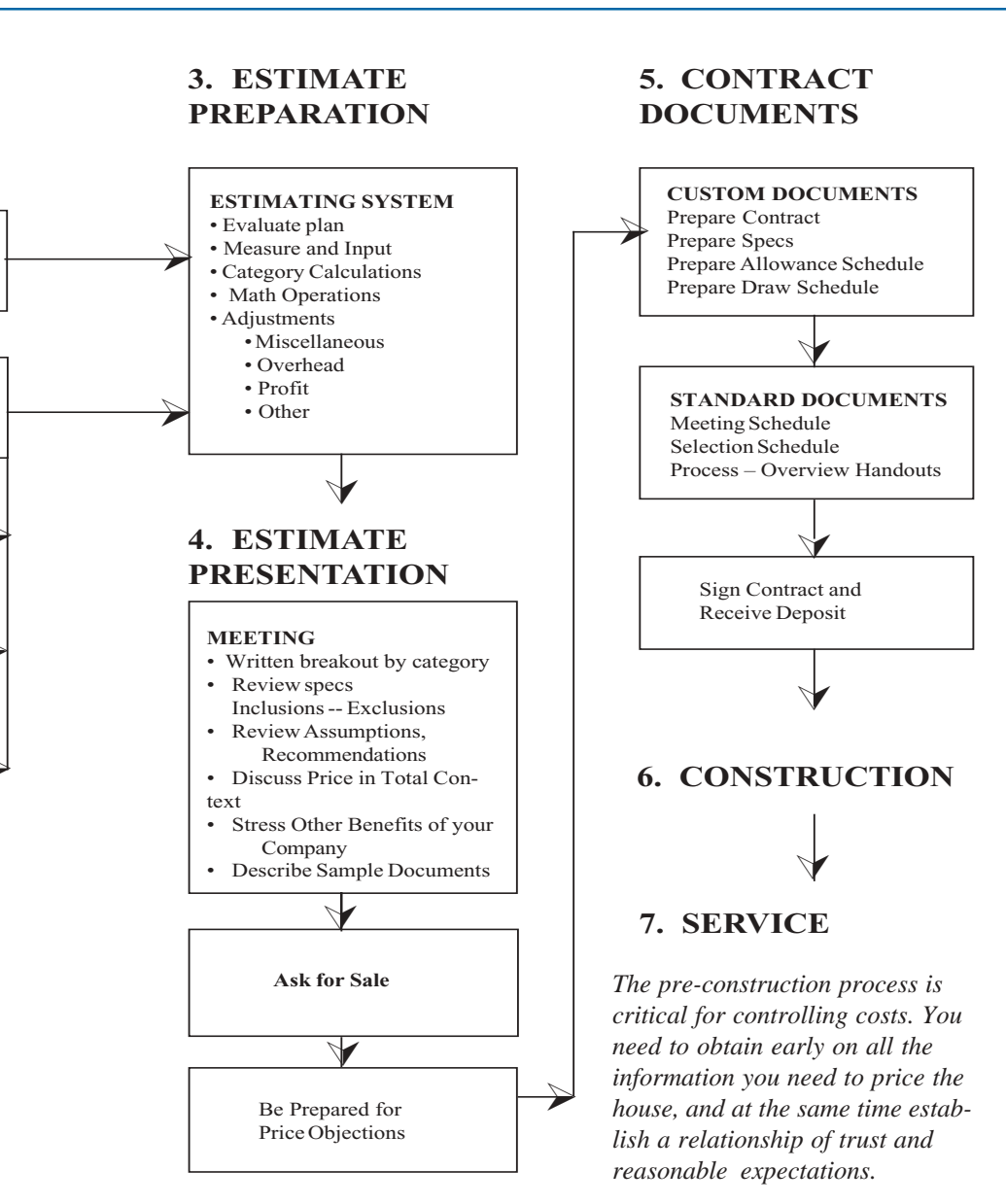
At least once a month you need to analyze your costs and income in each category. Look at not only the dollar amounts, but at the ratios. In examining your **Job Cost Report**, determine if your expenses are in line with your estimated budget, and are in sync with your percentage of completion. If an item is out of line, find out why. Was there a change in specifications? Can you recover part of the cost through a change order? Were subcontractor bills in line with their estimates?

Go through each project category by category and line by line. If there is a discrepancy between estimates and actual costs the time to find out about it is early in the construction, when some compensating savings can be found, rather than at the end of the project.

This is the concept of Management by Exception. Focus your energy on those areas that need attention, rather than getting lost in the details. Controlling the ratios allows you to grow without losing control, and allows you to see the big picture of where you are, and where you need to go.

Summation

The major benefit of pre-construction is in reducing expensive construction mistakes before they happen. Money lost in the pre-construction stage can rarely be made up on the construction stage. Your client contact process should establish realistic expectations for quality and schedule, and communicate client responsibilities in the construction process. Your estimating system should be complete, organized, accurate, and timely. Scheduling systems should be realistic and clearly establish milestones for client decisions. Your job cost accounting system should provide you early warning of any cost overruns or unbudgeted expenditures. Only by constant diligence can a builder maintain profit margins and enhance competitiveness throughout construction.



Ask AI by Al Trellis

Fixed Price vs. Cost-Plus

Q: With the escalation of labor and materials cost in my area, I've been thinking about using a cost plus contract rather than the fixed-priced contracts I've used in the past. What are the advantages and disadvantages of this approach?
— Confused in Cleveland

A: In our market, customers prefer fixed-price contracts. Such contracts make customers more comfortable since they know how much they are going to pay. The most obvious drawback of fixed-price contracts is price increases. If lumber prices go through the roof in the middle of a job, they can destroy your profits and more. The way around this is to include an escalator clause in your contract or negotiate deals with your suppliers.

The problem with the cost-plus contract is the myth that it creates a better relationship between the client and the builder. In reality, clients often use a cost-plus contract because they want to run the job without assuming the commensurate responsibility. Takes these cases:

A client asks you to get three bids and then dictates that you use the lowest priced subcontractor. You would have preferred one of the others, who is more reliable and does higher quality work. The clients picks the subcontractor, but keeps you responsible for timeliness and quality.

Clients visit the job site and see a trash pile with a lot of scrap lumber. They immediately want to know why their money is being "wasted" and how much other material they've paid for has been "trashed."

There is more than one way to successfully contract for work. The secret is not so much how you choose to write the contract, but to be very good at whatever you do, with good paperwork, proper systems, and excellent on-site management.

A Pattern Language by Paul Sharp

Farmhouse Kitchen

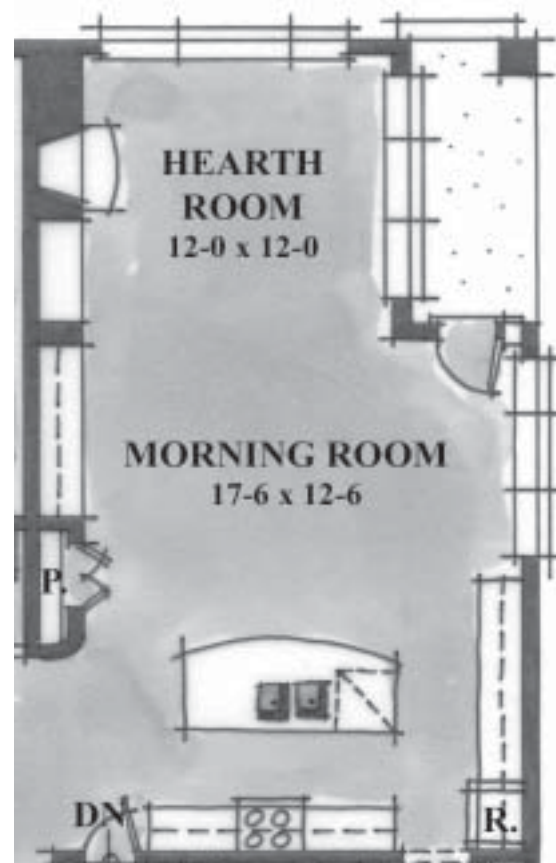
Christopher Alexander wrote *A Pattern Language*, outlining over 250 rules of thumb that affect home design. In this series of articles, we've highlighted some of our favorite patterns.

139. Farmhouse Kitchen

"The isolated kitchen, separate from the family... is a hangover from the days of servants. Therefore: Make the kitchen bigger than usual, big enough to include the "family room" space, and place it near the center of the commons, not so far back in the house as an ordinary kitchen. Make it large enough to hold a good big table and chairs, some soft and some hard, with counters and stove and sink around the edge of the room; and make it a bright and comfortable room."

A "Farmhouse Kitchen" doesn't mean a rustic appearance, but rather the incorporation of social and activity space within the kitchen itself. A large active kitchen is one of the most important sales features. With our informal lifestyle people tend to eat in the kitchen rather than the dining room. At the same time they serve as a social center. Kitchens should be posi-

tioned so they have immediate access to the dining and family areas. They should be lively, active and sunny rooms.



In the house above, the kitchen opens to the morning room and hearth room. House plan by David Court.

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Contributors

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Quote of the Month

"People are very open-minded about new things - as long as they're exactly like the old ones."

— Charles F. Kettering.

IN NEXT MONTH'S ISSUE

Back to Basics: Speed the Schedule

The faster the turnover (less time to build, less time between houses) the greater the profits. Part of this increase is due to increased volume, and part due to lower overhead per house.