



The Newsletter for Profit-minded Builders and Contractors

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Back to Basics: Managing the Money

by Paul Sharp and Bill Watkins

Success in the building industry is based on controlling two factors – money and time. Last month we discussed controlling time. This month we will discuss controlling the money.

Controlling money in the building business is a complicated process. We control revenue and potential costs through better estimating. We control construction costs through better design and better site supervision. We control overhead through better management and tight financial controls. But all of these measures presume an efficient system for keeping track of expenses through good accounting procedures.

If done correctly, accounting is more than the routine recording of all income and expenses. It can also provide the management tools a builder needs to determine if the money is being spent correctly, to identify problems in procedures, and to sharpen competitiveness.

Most builders have an accounting system of some kind, even if it's just balancing the checkbook. However, these systems often do not provide the information the builder needs in a simple, easy to understand format.

If you don't control spending and overhead, it will control you.

There are four steps builders and contractors need to take to improve their money management. These are: 1) Set up your financial information system, 2) Target your profits, 3) Analyze monthly results, and 4) Review variances.

SET UP your System

A simple computer program, such as QuickBooks, can provide the information you need – if you know how to ask for it. While accounting needs vary among different builders, I suggest adopting the National Association of Home Builders (NAHB) chart of accounts, and modifying

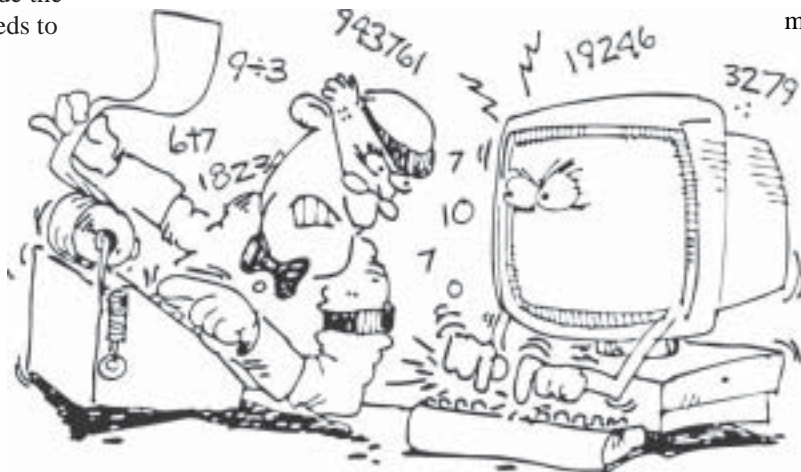
it to meet your needs. Then track your costs and revenues in each of these categories.

The Four Financial Reports

Most accounting systems produce these four reports: 1) Income Statement, 2) Balance Sheet, 3) Job Cost Report, and 4) Cash Flow Statement. You should set up your reports so that they report not only dollar amounts, but also calculate the percent of sales each category represents. These are your operating ratios. Dollar amounts are difficult to compare month-to-month, but your operating ratios should be relatively consistent.

The **Income Statement** is the best indicator of your financial situation. It represents the money coming in and going out of your company. Your **Balance Sheet** tells you how much cash you have, how much you owe, and how much other people owe you.

The **Job Cost Report** is used to track expenses on a project by project basis. The **Cash Flow Report** compares anticipated income and expenses with actual cash flow. You can use this to anticipate cash demands ahead of time to avoid last-minute borrowing.



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Back to Basics

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Your Three Money Masters

There are three masters that all builders must serve with data from their financial information system. Each of these masters may require different financial information. Your first master is Uncle Sam. We all have to pay taxes, and if you are like most builders, you want to defer paying your share as much as possible. The second master is outside money (your bank or outside investors). They require you to prepare financial statements within generally accepted accounting principles. But the most important master is yourself. You need to see financial information in a format you can use to target your profits, analyze your monthly results, reduce your variances, and anticipate problems before they become serious.

Many builders do not realize how they can use the same financial information that is needed by Uncle Sam and their banker to improve the profitability of their business. As part of a builder's normal accounting process, business transactions are recorded in journals and ledgers. In most organizations this information is given once a year to the builder's outside CPA who summarizes the information and prepares the tax return and financial statements for the bank.

Very few builders that I know spend the time interpreting what the statements really are saying. This is a mistake. By analyzing their financial information a builder can see where he has been and get a better understanding of where he is going. Waiting a year to discover that your overhead is out of line is too long. If you analyze those costs monthly you can do something about them before it's too late.

TARGET for Profit

Profit should never be simply an afterthought – the amount left over after all expenses are deducted. You should determine up front how much profit you want to make. Profit is over and above the reasonable salary you pay yourself for the work you do. Profit is compensation for the investment, entrepreneurial energy, and risk you undergo in running a business. For most builders, this amount should be in the range of 5-10%. The

amount of profit you can actually make depends on your market, your competition, and your management efficiency.

Second, you need to target the amounts you spend on activities that generate additional revenue. Marketing, if done properly, is not an expense. It is an investment in future profits. Most builders do not target adequate expenditures for marketing. Target 1-2% for marketing, (or more if you want to grow faster).

Then you need to budget for your operating expenses. This includes salaries (including one for yourself) and overhead (rent, office equipment and supplies, phone, vehicles, etc.) Budget a realistic amount, without getting extravagant. For most custom builders, this should be in the range of 7-12%.

Suppose that you want to make twenty percent profit and overhead (gross margin). In order to generate that margin, you need to know your lot costs and direct construction costs. Together, they can total no more than 80% of the sales price. If you know your costs and your profit margin, it is simple to calculate the sales price. Or, if you know what price the market will tolerate, you can calculate budgets for each of the categories. These targets for profit, operating expenses, and direct construction costs become the driving force behind your money management system.

ANALYZE Finances 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. Go through the **Income Statement** carefully. Do a side by side comparison of the present month and the two preceding months, to see if there are any discernible trends. Wherever you see a significant variance from your target ratio, circle it and investigate why. If it is a direct construction cost, you need to go to the Job Cost Report to find the cause.

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 the **Balance Sheet**. Was there any increase in payables or receivables? Do you need to spend additional effort in collecting monies owed? Look at the **Cash Flow Report**. Are there any significant anticipated demands for cash next month, and do you have the cash on hand to deal with them?

By monitoring certain key ratios you can get a better understanding of where you've been and where you're going. Two ratios which are important for a builder to monitor are the current ratio and debt to equity ratio.

Current Ratio

The current ratio is the most popular measure of a company's solvency. It compares the amount of current assets with which payments can be made to the amount of current liabilities requiring payment. Analysis of this ratio will indicate shortages in working capital or a reluctance to utilize available resources. The higher the ratio, the more capable the company is in meeting its current obligations.

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Debt to Equity Ratio

The debt to equity ratio is a key measure of the company's leverage factor. Banks strongly rely on this ratio in their evaluation of a builder's credit worthiness. The higher the ratio, the more risk is being assumed by creditors. A lower ratio usually indicates that the company has more borrowing capacity and greater long-term financial stability.

$$\text{Debt-To-Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Total Owners' Equity}}$$

Job Cost Analysis

While the Income Statement assists a builder in evaluating the overall profitability of their jobs, it does not provide the builder with an analysis of the profitability on a job by job basis. The primary purpose of preparing and evaluating Job Cost reports is to provide reports on a timely basis which assist you in controlling and managing construction costs.

At a minimum, Job Cost reports can be used to compare estimated to actual expenditures for various areas of work performed on each job. More

sophisticated Job Cost reports can also be used to take into account projected costs to complete as well as analyze the status of labor and subcontract costs.

Regular preparation and analysis of Job Cost reports can be a valuable tool in helping to identify and correct problems which can lead to cost overruns before it is too late.

Cash Management

Did you know that the construction industry accounts for the second largest number of bankruptcies next to mom and pop restaurants? Did you also know that the number one reason for failures of builders is not lack of profitability but poor cash flow? One way of improving your odds of survival and also increasing your profitability is by cash flow forecasting. Cash flow forecasting is the planning of cash availability and requirements for a specified period of time.

Cash flow forecasting can be beneficial in a number of ways. It can provide you with a means to evaluate growth and changes in their business. In addition, it provides a method of identifying the real cost of money as it relates to time.

For your banker and yourself, cash flow forecasting reflects a sophisticated level of organization and planning which can lead to increased credit and reduced interest rates. Cash flow forecasts should be a part of the overall budgeting and planning functions. Forecasts can be prepared both on a project-by-project basis and overall company basis for both long term (annual) and short term (monthly and weekly) periods of time.

Construction Cash Flow Projections

As part of the planning process for each construction project the builder should identify the amount and timing of cash needed throughout the job. The cash flow projection should be a by-product of the scheduling and estimating functions. By knowing estimated project costs, when they are anticipated to be incurred, the payment terms for materials and subcontractors and the billing and collection terms that you have with the customer, a cash flow forecast for the project can be easily prepared.

Company Cash Flow Projection

After completing cash flow projections for each project, the net cash available or required from each project can be summarized and used to prepare an overall company related cash projection. This projection consolidates construction cash requirements with company overhead expenses.

By preparing and monitoring cash flow projections the builder truly is looking into a crystal ball. What the crystal ball is saying can be essential to the profitability and ultimate survival of your company.

REVIEW for Variance

In analyzing your monthly financial reports, pay particular attention to the operating ratios, and their variance from budget. Start with the big categories, and then look at the details. If these are following a trend, then you need to determine a course of action to reduce the variance. If you discover, for example, that your overhead is gradually creeping up, then you either need to find a way to reduce overhead, or you need to increase sales to keep a constant ratio. If necessary, adjust your targets to better reflect reality. This is the concept of Management by Exception. Focus your energy on those areas that need attention, rather than get lost in the details. Controlling the ratios allows you to grow without losing control, and allows you to see the big

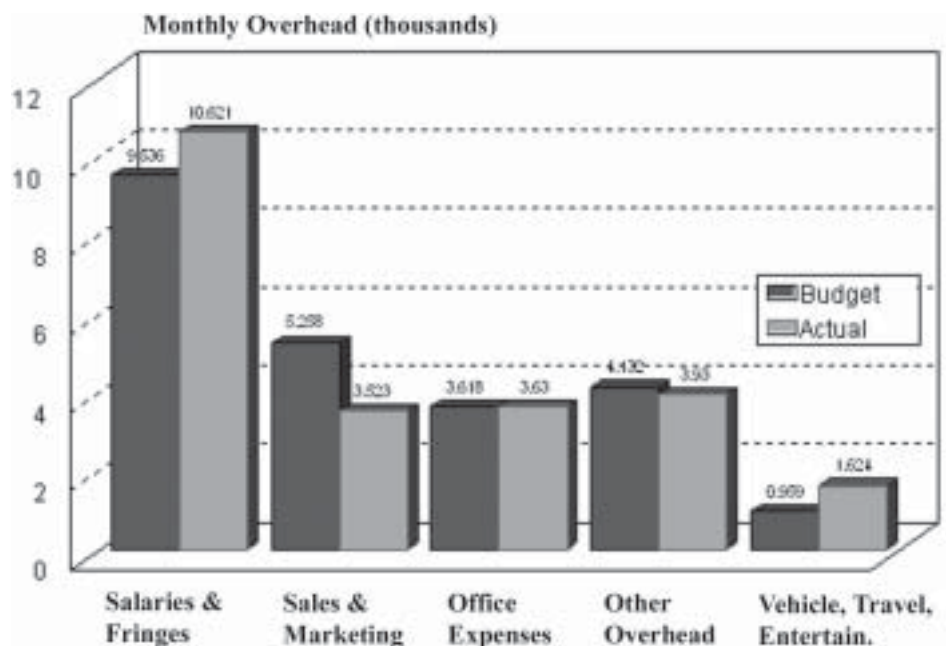
picture of where you are, and where you need to go.

Look at the bar graph shown below. It offers a pictorial view comparing budgeted to actual sales, gross profit and net income for the month and the year to date. Such graphic comparisons can quickly focus the mind on where the problems are.

Next look at the detailed schedule of operating expenses to see which expense categories are out of line. Look at your year to date variance and compare it to your budget. If a category will exceed its annual budget you will either have to bring another overhead expense category under budget, or increase your gross profit. If neither of these is feasible, you'll have to accept less profit for the year.

Also look at variance job by job. If you notice that a particular job is running below your targeted profit, then take the next step to analyze the job cost report and investigate what line items already exceed budget, as well as looking for ways to reduce costs for work still to be completed. Using Purchase Orders, speeding up the construction schedule, as well as reevaluating certain items in the house are just some steps that you may be able to take to turn this job around.

By following this four step process, (set up your system, target your profits, analyze expenses monthly, and review for variance) you can control your own profits and costs so that you consistently beat the averages, and avoid many of the financial problems faced by builders today.



Graphic comparisons let you quickly identify discrepancies in cost accounting.

Ask AI by AI Trellis

Calculating Net Profit

Q: Our company will build approximately 20 homes this year at an average price of \$450,000. What should our net profit and overhead percentages be?

– Mystified in Memphis

A: Margins vary across the country, but your minimum net profit should be somewhere between 5 and 7 percent. Overhead is more difficult to benchmark because builders use different methods to account for items like the owner's salary. As the owner, you can increase overhead and lower net profits by taking out a large salary and generous benefits. Or you can draw a small salary and benefits to build a larger net profit, which might then be reduced by a substantial bonus. More conservative builders leave the profits in the company and use them to buy more land and create additional opportunities.

While it's difficult to suggest a specific overhead percentage, I will say that most custom builders of your volume successfully run their companies with the ratio of approximately one employee per \$1 million to \$1.4 million in gross revenue. That would mean you would need 9 to 11 employees, including yourself. The most efficient builders of your size in the South and Southeast keep their overhead below 10 percent. Again, much depends on how an individual builder does the accounting. Some builders take certain costs, such as direct site supervision, and attribute them to each job, following the NAHB chart of accounts. Others take all supervisory and labor personnel, call it overhead, and charge it off at the corporate level. These kinds of factors substantially affect generalizations about percentages. The critical point isn't that you achieve a certain percentage, but that you generate sufficient profit to ensure your financial health.

A Pattern Language by Paul Sharp

Indoor Sunlight

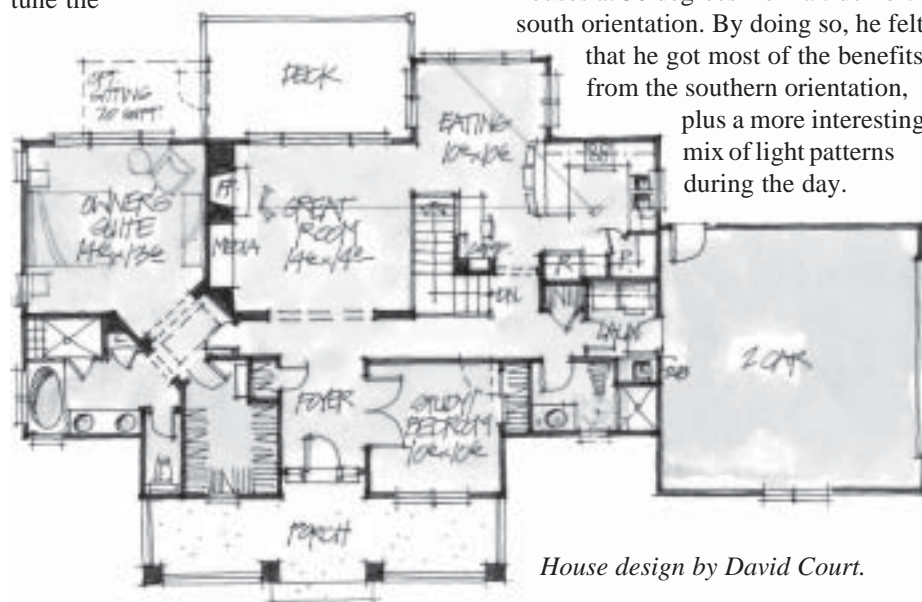
Christopher Alexander wrote *A Pattern Language*, outlining over 250 rules of thumb that affect home design. In this series of articles, we've highlighted some of our favorite patterns.

128. Indoor Sunlight

"If the right rooms are facing south, a house is bright and sunny and cheerful; if the wrong rooms are facing south, the house is dark and gloomy. Therefore: Place the most important rooms along the south edge of the building, and spread the building out along the east west axis. Fine tune the

arrangement so that the proper rooms are exposed to the southeast and the southwest sun. For example: give the common area a full southern exposure, bedrooms southeast, porch southwest. For most climates, this means the shape of the building is elongated east west."

While this concept is important, it must not be done in such a way that it creates awkward traffic flow through the house. In addition, a particular lot may not lend itself to a southern orientation. However, whenever this orientation is possible you should take advantage of it. Frank Lloyd Wright tried to orient his houses at 30 degrees from a true north-south orientation. By doing so, he felt that he got most of the benefits from the southern orientation, plus a more interesting mix of light patterns during the day.



House design by David Court.

On the Level is distributed monthly by your local lumber dealer or supplier. Visit our web site at www.HBNnet.com
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Quote of the Month

"Computer: a million morons working at the speed of light."

—David Ferrier

IN NEXT MONTH'S ISSUE

Back to Basics: Pick the Right People

A company is only as strong as the people that comprise it. If you hire the best people available, pay them what the market determines they're worth, and constantly update their skills, your company will survive and thrive.