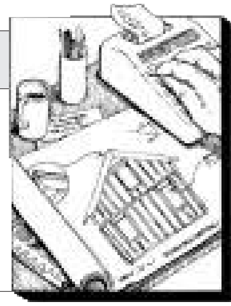
Measuring Success

by Sal Alfano



The first year I was in business, I built one house, framed a second, and completed two small remodeling jobs. Off to what I thought was a great start, I was anxious to see how I compared with others in the area who were doing the same kind of work on the same scale. So I asked a builder friend if he'd had a good year. "Business is great," he told me. "I did over $100,000 last year." When I asked other builders the same question, I got similar answers. I soon realized that among small builders, the primary measure of success was total volume of work. "Bigger is better" was the predominant business philosophy: The more work you do, the more money you make.

Many small builders gauge their success by volume because that is the only number they are sure of. As long as they pay their subs and suppliers, and still have money in their checking accounts, these builders assume they are making money because they are doing more and more work. But as volume increases, so does inefficiency. A small builder whose company grows too fast too soon may appear to be making money when, in fact, he is treading water or even losing money.

Volume vs. Profit

As an indicator of success, volume is very misleading. For one thing, volume (also called *construction revenue* or *sales*) includes amounts paid for materials, labor, and subcontractors — the *direct costs* of construction. This money does not stay in a builder's pocket — it only passes through his checking account.

Two types of profit. You'll get a much better idea about whether you're making money or not if you know your *gross profit* and *net profit*. Gross profit is the amount left over after everyone directly associated with all of your projects has been paid. Calculate gross profit by subtracting direct costs from sales. For example:

$200,000	Sales
– 150,000	Direct Costs
$ 50,000	Gross Profit

But gross profit does not go directly into your pocket either. It includes *indirect costs* — expenses associated with doing business that are not, however, billable to a specific job. For a small company, indirect costs typically include the costs of running an office (such as phone service, insurance, heat and light) as well as administrative expenses (the salary of a part-time bookkeeper).

The true measure of how much money your company is earning is *net profit* — the amount your company earned over and above all expenses. To calculate net profit, subtract indirect costs from gross profit:

$50,000	Gross Profit
– 40,000	Indirect Costs
$10,000	Net Profit

Planning for Profit

Gross profit is a reliable measure of financial success, especially when volume increases rapidly. The turning point usually comes when you stop working on site yourself, and spend most of your time estimating, meeting with clients, and supervising construction. This new arrangement creates a large indirect cost: your salary. Since you're not banging nails and billing your time directly to a specific job, your paycheck has to be covered by gross profit. If gross profit isn't high enough, you could be losing money, despite high volume.

Build a budget. Making a profit shouldn't be left to chance. At the start of each construction season, you should use figures from the previous year to create an estimate of what your expenses will be, and how much volume you will need to cover them.

Sophisticated financial budgeting is complex, but you can use a simplified five-step process:

- ***Step 1: Set a target net profit.*** Ideally, you should earn a net profit of between 5% and 10% of sales.
- ***Step 2: Estimate indirect costs for the coming year.*** Include all expenses not directly related to construction, such as office salaries, vehicle fuel and maintenance, phone charges, and office supplies.
- ***Step 3: Calculate the gross profit you will need to cover expenses and earn a net profit.*** Add the totals from the first two steps. For example:

$12,000	Target Net Profit
+ 45,000	Estimated Indirect Costs
$57,000	Target Gross Profit

- ***Step 4: Calculate the gross profit percentage for last year.*** Plug last year's sales and expense figures into the following formula:

$$\frac{\$50{,}000 \text{ Gross Profit}}{\$200{,}000 \text{ Total Sales}} = .25 \text{ Gross Profit } (25\%)$$

- ***Step 5: Calculate the total sales (or volume) needed to reach the targeted gross profit.*** Use this year's gross profit dollar amount from Step 3, and last year's gross profit percentage from Step 4:

$$\frac{\$57{,}000 \text{ Target Gross Profit}}{.25 \text{ Gross Profit } (25\%)} = \$228{,}000 \text{ Target Sales}$$

Admittedly, this new budgeted volume may be higher than last year's, but not simply because *bigger is better*. The increase in volume is tied directly to your expenses and to the net profit you want to earn.

Repeat these calculations throughout the year to make sure each job, regardless of size, is earning the targeted gross profit. If you discover early enough that gross profit is slipping below budgeted figures, you will still have time to find the root causes and make adjustments. ■

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