Diagnosing Your Business

by Judith Miller

To measure a person's physical health, physicians use certain standards — proper weight, cholesterol count, lung capacity, and the like. Without ever seeing the patient, a doctor can predict health and longevity based simply on the numbers. Similarly, you can track the health of your business using what I call *baseline numbers*. And just as a physician may prescribe a workout to help you lose weight, you can use your baseline numbers to diagnose business problems and decide on a course that will improve your company's performance.

What Are the Baseline Numbers?

Many builders already monitor the financial performance of individual jobs by comparing actual job costs to estimated costs in categories such as foundation, framing, finish carpentry, and so on. To do the same thing for the performance of your company as a whole, you need to know how to calculate seven important baseline numbers: gross sales, close ratio, average job size, gross profit, overhead, net profit, and owner compensation.

Gross Sales

The most basic baseline number — and the easiest to calculate — is gross sales. To find gross sales for the past year, use your financial statements or your tax returns — even the deposit records in your checkbook. Just be careful to include only income from construction jobs, not interest, insurance dividends, or other types of income. Since the total will be used in several other calculations, you don't want to skew the results with a number that's too high or too low; that would be like weighing yourself with your toolbelt on.

By comparing one year's gross sales to the next year's, you can calculate your rate of growth. By averaging gross sales over a number of years, you can determine the long-term stability of your business.

Close Ratio

A fly fisherman evaluating a particular stream asks himself how many times the fly must hit the water before he lands a fish he can keep. Similarly, when evaluating the marketing plan for a construction business, contractors need to ask how many leads they must get before they sign a job. (For a more complete discussion of lead tracking, see *Business Forum*, 9/94, and "Selecting Quality Customers: The Art of Prequalification," 2/95.)

To compare the number of leads received to the number of jobs signed, you need to calculate your "close ratio." Using records for a given period of time (usually a year), divide the number of leads that turned into jobs

by the total number of leads. For example, if in 1995 you received 250 leads and signed 25 contracts, your close ratio is 10%.

Average Job Size

Along with the close ratio, knowing the size of an average job helps you to predict future sales volume. For example, if your close ratio is 10% and your average job size is $15,000, you can estimate your total sales volume from the number of leads you receive. The more frequently you evaluate your leads, the more accurate your sales projections will be (see "Planning for Growth," 5/95).

To find average job size, divide annual gross sales by the total number of jobs completed. Throw out any jobs that are so large or so small that they might skew the average. For example, if you completed 10 jobs in 1995 and billed $250,000 for those jobs, your average job size would be $25,000 ($250,000÷10). But if one of those jobs was for $100,000, you should throw it out and divide $150,000 by 9, for a more accurate average job size of $16,600.

Gross Profit

Once you know your gross sales, you can determine some other important baseline numbers. One of the easiest to calculate is gross profit (GP). While many companies judge performance in terms of sales volume, more sophisticated builders use gross profit as an indicator of financial health. (For a more complete discussion of gross profit, see *Business Forum*, 10/94.)

Gross profit is the dollar amount left over after paying all direct job costs, but it's usually expressed as a percentage of sales. To find your gross profit percentage, subtract all direct costs from gross sales — direct costs include materials, labor, subcontractors, equipment rentals, and anything else that is directly incorporated or consumed in a specific construction project — then divide the result by gross sales:

$$GP(\%) = \frac{Gross\ Sales - Direct\ Costs}{Gross\ Sales}$$

Your gross profit percentage should be the same or nearly the same for every job, regardless of size. Over the course of the year, a steady gross profit percentage indicates good performance; a drop in gross profit is an early warning sign of financial trouble.

Overhead

The accuracy of your baseline numbers depends on properly separating direct costs from overhead (OH). Overhead should include only those expenses that are related to the company as a whole, not to a particular job. That means that builder's risk insurance for a particular job, for example, is a direct cost, but general liability insurance, which covers all jobs, is a part of overhead. With respect to labor, an owner's time spent on-site — whether wearing a toolbelt or supervising subs — is a direct cost to that particular job; but an owner's time spent meeting with prospective customers or with a banker or insurance agent is a part of overhead. The dollar total of all overhead when divided by gross sales yields your overhead percentage:

$$OH\ (\%) = \frac{Overhead\ (\$)}{Gross\ Sales\ (\$)}$$

Most overhead expenses remain more or less fixed: Office rental costs, utility payments, office supplies, and other similar costs vary only slightly from year to year. Because direct costs are balanced by payments to employees, subs, suppliers, and other vendors, any shortfall in gross profit means less money to pay for overhead. And that means less money left over for net profit.

Net Profit

The amount that remains after subtracting overhead from gross profit is called net profit (NP). Net profit is the best indicator of a company's short-term success. To find your net profit percentage, divide the dollar amount of net profit by gross sales:

$$NP\ (\%) = \frac{Net\ Profit\ (\$)}{Gross\ Sales\ (\$)}$$

Again, if your gross profit starts to slip, the difference will be made up out of net profit. If it slips too much, you'll end up with a net loss.

Owner's Compensation

For working contractors, some part of the owner's salary is a direct cost — in other words, it's billable to a particular job. Often, however, the owner's work is administrative and deals with issues that affect the company as a whole. This portion of the owner's salary should be included in overhead, then subtracted from net profit. This will give an accurate picture of the company's true net profit. ■

Judith Miller consults with local builders in Oakland, Calif., about accounting, financial management, computerization, and office procedures.