The Language of Accounting

by Mike Weiss

Have you ever sat down across from your accountant or CPA for an update and heard the words flow by without any idea what he or she was saying? "We have a problem," your CPA might say to you. "Your current ratio is way too high. What are we going to do about it?" Your reaction might be, "Boy, oh boy, what is this going to cost me?" or "How long have I got?" Or he might say something like, "Your ROI is nearly 200%. I think it's time we take some money and run."

If your accountant said either of those things to you, you might want to run home and pack a bag for Brazil, or look for a place to hide, because, with that much wrong, big trouble couldn't be far behind, right?

Actually, what your CPA (we'll call him or her Charlie) is telling you in both instances is that you probably are holding too much cash in your company and should pay yourself a bonus or a dividend. ROI, for example, stands for "return on investment"; "current ratio" is explained below.

Learning Accountingese

You probably don't expect Charlie to know what you mean when you say, "By tomorrow noon, I expect to be all decked out over at the Jones job." He may be forgiven for puzzling over a mental image of you dressed in a tuxedo, pounding nails. As contractors, we learn the language of trade contractors and vendors to make sure we're on the same page when discussing materials, labor, and equipment. The better the communication between crew and contractor, the better the bid and the better the job.

By extension, then, to benefit from some of our best potential advisors, accountants, we ought to learn at least some of their language. If we were so lax on the construction side of communication, we might be getting shingles in the master bath and toilets on the roof.

When you hire an accountant, you're hiring an expert, someone who should understand your business and your product. What you're paying for, in addition to your quarterly reports and your tax return, is advice from someone in an excellent position to save you money. In order to take advantage of that advice, you need to understand him or her.

The language of accounting is a little like computer lingo. Most people use some of the terms freely but may not know exactly what's meant by them. When you have a financial problem — for example, you think you should be making more profit for the amount of business you're doing — where do you begin to look for the solution? Today's contractor is required to keep plenty of records; to know about OSHA, lead toxins, HAZCOM; to offer a good assortment of benefits, have a 401k program, deal with absenteeism; and still have time to go to his kids' Little League games. To manage all this without going bananas, owners, like their workers, need to undergo some training.

Where to Begin

Sit down with someone at your accounting firm who can explain the terminology. Together, you can determine the range of gross profit required to pay yourself a good salary and realize an 8% to 12% profit on your sales volume. If you're selling $800,000 of remodeling, you should be paying yourself an annual salary of $75,000 to $80,000, and seeing a profit of $70,000 to $80,000 before taxes. If that seems like pie in the sky, you should work through the concept with your accountant.

The accounting reports that are standard with software programs like QuickBooks Pro, Peachtree, Timberline, and others are worth their weight in gold. They can tell you how well you're doing on the new job *before* the job is over. But only if you know how to interpret them.

All of these programs generate the same kind of reports and use the same terminology. Let's look at some of the most common reports and terms used in describing a company's position and performance.

Balance Sheet

A balance sheet is made up of three of the five basic accounting categories:

- assets — what you own
- liabilities — what you owe
- equity — what's free and clear

(The other two basic categories are income and expense, discussed further on.) The term "balance" refers to the fact that assets = liability + equity.

A statement of condition, or a balance sheet, is a measure of a company's wealth, or equity, as of a specific time. It is prepared, for example, "as of the close of business, December 31, 2001." If you apply for a business loan, your banker or lender will typically ask you for a financial statement, including a balance sheet. Why does he want to know? What information about your company can a lender extract from your balance sheet? Your "current ratio" is one term your lender will want to examine. That's the ratio of your current (mostly liquid, or readily converted to cash) assets, divided by your current liabilities (the things you owe now and soon). If that ratio is around 1.5 (assets) to 1 (liabilities), you're in pretty good shape — you have about a 50% reserve over what you owe after you pay off your liabilities.

Your current ratio can thus indicate that you have working capital and aren't living hand to mouth.

When Charlie asks if you've acquired any fixed assets in the last three months, he's asking if you've made a tangible purchase, like a house, a barn, or 20 acres of industrial land, in that time.

If you have current and fixed assets, it stands to reason that you should have current and fixed liabilities, right? Well, almost. Current liabilities are those amounts we owe over a fairly short period of time, as in next week or over the next three months. Fixed liabilities are referred to as long-term liabilities. These may include a mortgage on a building, the balance of payments due on your truck beyond this year, or the money due on the promissory note you're paying off while buying the business from your former partner.

Income Statement or Profit and Loss

A P&L, or profit and loss statement, covers a specific period of time — for example, a quarter — and contains your income and expense information.

One of the most important factors to a remodeler or builder is something called the cost of goods sold, or COGS. COGS is, in its broadest sense, your job cost, what it costs to build your project. When we subtract the COGS from the sales price (income), the difference is your gross profit (GP). The GP is the money you use to pay your office rent, your salary, insurance, and interest, all categorized as general administrative and overhead, or GA&O, expenses (sometimes called fixed expenses or fixed overhead). When you divide your GP by the amount of sales, or income, for the same period, the result is called your gross margin. Gross margin (GM) is expressed as a percentage; for a remodeling business, it should be a minimum of 31% to 34%. Hang on, we're getting there.

Finally, we have the heartbeat term: profit. Sales minus COGS gives you your gross profit; your GP minus your GA&O equals your operating profit. Is this the bottom line? Not quite. This is called the operating profit because you haven't paid taxes on it yet. Only after taxes are paid or provided for are you truly at the bottom line, or net profit.

Attaining Fluency

Understanding the relationships between these terms and how the various ratios and percentages are used can give you access to a great deal of valuable information. You can discuss your operations with a contractor from a different area and get a good comparison between his or her company and yours. The members of several organizations of noncompetitive remodelers compare their financial information for mutual advantage. I belong to the NAHB Remodelors Council's Remodelors 20 Club; other good groups include Business Networks and Remodelers Advantage.

It isn't necessary to become an accountant to understand your business, but if you understand the common terms used to measure your financial progress and manage corrective measures, you'll be able to speak the language of success.

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Resources

Remodelor 20 Club
800/368-5242
www.nahb.com/builders/remodelors_council_for_builders.htm

Business Networks
800/525-1009
www.businessnetworks.com

Remodelers Advantage
301/490-5620
www.remodelersadvantage.com