Accounting Habits of Successful Contractors

by Stuart Lerman

In 20 years as an accountant in the Chicagoland area, I've seen a lot of my contractor clients go through business ups and downs. In my experience, the most successful are those who know what profit they need to make and keep a close eye on job costs. I consider it part of my job to teach less experienced clients how to set profit goals and achieve them.

So I ask new clients to do three things. First, I ask them to make a budget, or cash flow plan, detailing their routine business expenses. Expressed as a percentage of their expected volume, this sets their target rate of profit (see Figure 1, next page). Second, I ask them to get on a calendar — to schedule their accounting routine so that they keep their books up to date and routinely compare the profits they're making on each job against their target profit rate. Third, I ask them to send me their data monthly and meet with me quarterly, so I can help them review where their business stands. Over a couple of years, many of my new clients go from not even balancing their checkbook to having a sophisticated understanding of their company's finances.

Expenses and Gross Profits

The money you charge for a job minus the cost of that job equals your gross profit. Take a $100,000 addition: If your cost for labor, materials, and subs (along with minor details like permits) comes to $70,000, and the contract price is $100,000, your gross profit is $30,000. Your gross profit rate is 30%.

Most construction companies need to make a gross profit rate of 30% or better to succeed over the long haul, but it varies from company to company. The rate you need to make depends on your own situation. In simple terms, the profit you make on jobs has to cover your company's operating expenses, plus your income (as owner, you should always take a regular salary).

The example in Figure 1 reflects expenses for a small contracting business over three quarters of a year. Some categories, like the owner's draw and the rent, are regular and predictable. Others, including computer expense, telephone, and insurance, fluctuate from month to month. But over 12 months, this small company can expect to lay out nearly $140,000 in operating expenses — an average of about $12,000 monthly, including the owner's salary.

That $140,000 has to come from the profit on the company's jobs. The higher the profit rate, the less volume you need. To break even on an annual basis, the company could plan to make a 25% gross profit on about $560,000 of sales volume, a 30% gross profit on about $467,000 of volume, a 35% gross profit on about $400,000 of volume, or a 40% gross profit on about $350,000 of volume. The company I looked at to create this example actually did about $600,000 of volume in 12 months at a 27% gross profit, earning net profits of about $22,000 over and above the owner's salary.

To keep profits on track, enter bills daily, review specific job reports weekly, and analyze big-picture financials monthly

To set your target rate of gross profit, look at your financial history. By totaling expenses over a long period — like nine months — and finding a monthly average, you have a good baseline for projecting annual expenses. The longer the period you use to determine your baseline, the better the information: A year is better than six months, and three years is even better. If your company is brand new, get an accountant's help in estimating reasonable expenses. A good accountant who has experience with construction clients can give you a rough idea of what's typical in your market.

A firm estimate of his baseline gross

Nine-Month Expense Budget

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	9-mo. total	Monthly avg.	Yearly est.
Advertising	628	0	390	0	0	806	351	0	384	2559	284	3412
Computer expense	4004	0	750	0	0	0	0	52	0	4806	534	6408
Dues and subscriptions	0	0	146	2000	745	385	2978	100	0	6354	706	8472
Insurance—general	1542	1637	2108	0	1389	2535	0	795	3082	13088	1454	17450
Insurance—health	2042	870	704	869	1326	-362	3548	1609	1717	12323	1369	16430
Professional fees	0	1218	0	0	0	0	914	0	1870	4002	444	5336
Meals and entertainment	45	264	366	198	624	122	62	1199	495	3375	375	4500
Travel	0	170	0	0	0	0	0	0	0	170	18	226
Office supplies	0	31	652	0	1216	-222	0	15	15	1707	189	2276
Postage	136	0	0	0	80	0	0	0	142	358	39	477
Officer salaries	3200	3200	4000	3200	4000	3200	4000	3200	3200	31200	3466	41600
Payroll taxes—admin	293	293	329	245	306	245	306	245	245	2507	278	3342
Scavenger	284	0	140	140	279	329	527	140	279	2118	235	2824
Telephone expense	941	-68	1188	-2	1205	504	99	491	38	4396	488	5861
Vehicle expense	0	25	0	100	126	354	0	0	1101	1706	189	2274
Rent expense	1200	1200	1200	1200	1200	1200	1200	1200	1200	10800	1200	14400
TOTAL Expenses	**14315**	**8840**	**11973**	**7950**	**12496**	**9096**	**13985**	**9046**	**13768**	**101469**	**11268**	**135288**

Figure 1. The example above reflects expenses over a 9-month period for a typical small contractor. Over a 12-month period, this company spends nearly $140,000 in operating expenses, including the owner's $800 weekly salary. Monthly expenses average almost $12,000. Profits on jobs have to cover those expenses. So if the company does $40,000 worth of volume in an average month, it can cover expenses with a 30% gross profit. That's the break-even target just to survive; for long-term health, the company should exceed that target and maintain an operating cash reserve.

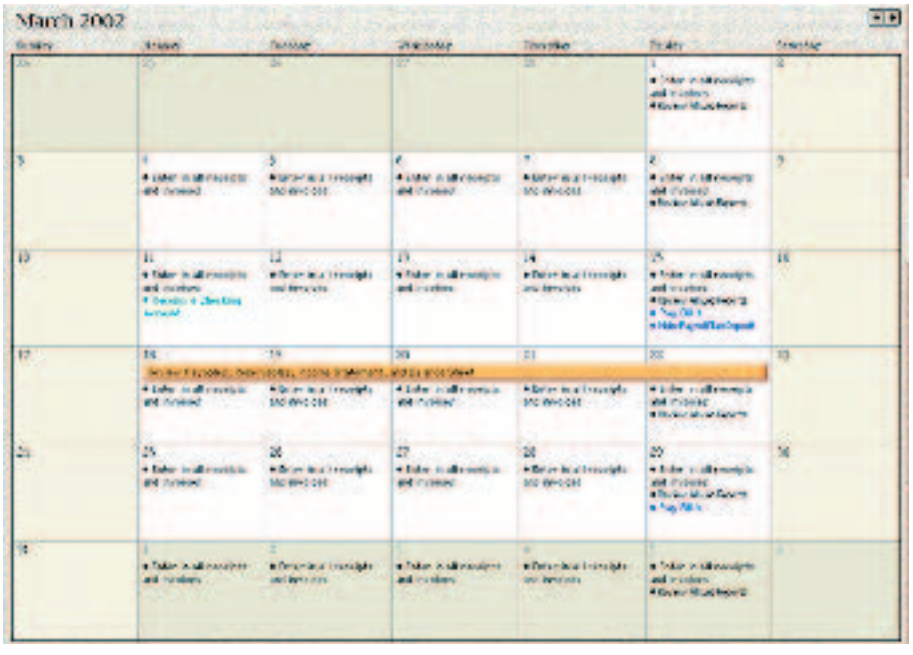

Figure 2. The author provides his clients with a monthly calendar to schedule their money-related chores. Entering bills and invoices is a daily task, even if the items won't be paid until later. Job cost reviews are a weekly task, and reconciling the checkbook and paying bills are monthly tasks. Finally, a whole week after mid-month is set aside for examining the company's payables, receivables, income statement, and balance sheet.

profit requirement gives the contractor a basis for evaluating jobs. He can look at his gross profit on each phase of each job. If it drops below his target rate, he knows he needs to correct something.

Minding the Books

Watching the numbers is a habit that business owners have to develop. It's an adjustment for a guy who's used to swinging a hammer rather than sitting in front of a computer. You have to adopt a systematic routine. There are some things you should do every day; other things, you should do weekly or monthly.

I often set up new small clients on a calendar. I literally take the calendar off my wall, photocopy the current month and the next two months, and we mark on the calendar what needs to be done when (Figure 2). Then we make a list.

Daily tasks. Here's the first item on the list: Every day, enter in your bills. Even if you file your taxes on a cash

basis, you should run your business on the accrual basis — enter bills from your subs when you receive them, and enter bills to your customers when you send them, rather than waiting until you write a check or make a deposit. Even if you're questioning the bill or you don't have the cash to pay it, enter it into the system. Then you'll be able to generate reports that take into account payables and receivables, not just cash.

Weekly tasks. If you're entering in every invoice or bill when you receive or send it, and if you're billing customers promptly at the agreed-upon start or finish point, your job cost reports will show you current information for ongoing jobs. You'll know in the middle of a job whether it's working out according to plan. So for my contractor clients, on that three-month calendar we've copied, every Friday I mark down: "Review All Job Reports." In the construction industry, this is vital.

Most accounting programs will produce some version of the report in Figure 3 — a job cost report that shows estimated costs, actual costs, estimated gross profit, and actual gross profit. For a long job, you can break out reports by phase: foundation, framing, drywall, and so on. Whatever program you use, your accountant can show you how to set up reports that provide the information you need.

If you look at a job cost profitability report for every job, every week, numbers that don't make sense will jump out at you. The typical things that drive down your profit will stick out: lumberyards that overcharge you or charge twice for the same delivery, sales taxes you didn't allow for, subs who bill you for more than they estimated, labor costs that creep up because weather delays a job or because that new helper isn't pulling his weight, change-order work you paid for and forgot to bill out. It's all money out of your pocket, and the time to notice those things and take corrective action is during the job, not two months later.

A quick look at our example shows good news: The "Variance" columns show that actual costs were below estimated costs, and actual gross profits were above estimated gross profits. The actual gross profit rate was 40% for the window and door phases, a good healthy number.

However, a closer look raises questions. In the door phase, labor costs exceeded estimates, while materials costs were far below estimates. Are the materials costs accurate, or have some doors not been paid for? If some costs haven't been recorded, this report may exaggerate profits.

In the window phase, we see the opposite pattern: Materials costs

Job Cost Profitability Report
Estimate vs. Actual

Phase: DOORS Item Description	Estimated Cost	Actual Cost	Dollar Variance	Percent Variance
Dumpster or extra pickup	$50	$0	-$50	-100%
Materials	$1,800	$700	-$1,100	-61.1%
Caulk & coil	$20	$0	-$20	-100%
Wood casing	$40	$0	-$40	-100%
Miscellaneous expense	$25	$10.42	-$14.58	-58.3%
Direct labor	$550	$1,308.73	$758.73	138%
Subcontracted work	$0	$0	$0	0%
PHASE OVERHEAD	$220	$523.49	$303.49	137.9%
Phase total	$2,705	$2,542.64	-$162.36	-6%
Phase: WINDOWS				
Dumpster or extra pickup	$100	$0	-$100	-100%
Materials	$8,002	$9,036.48	$1,034.48	21.7%
Caulk & coil	$210	$0	-$210	-100%
Wood casing	$460	$233.82	-$226.18	-49.2%
Miscellaneous expense	$50	$0	-$50	-100%
Direct labor	$2,904	$1,341.03	-$1,562.97	-53.8%
Subcontracted work	$0	$0	$0	0%
PHASE OVERHEAD	$1161.60	$536.41	-$625.19	-53.8%
Phase total	$12,887.60	$11,147.74	-$1,739.86	–13.5%
Job Total				
Price	$23,000	$23,000	0	0%
Cost	$15,592.60	$13,690.38	-$1,902.22	-12.2%
Gross profit (dollars)	$7,407.40	$9,309.62	$1,902.22	25.7%
Gross profit rate	32%	40%		

Figure 3. This job cost profitability report shows actual gross profits at 40%, higher than the estimated profit of 32%. This is good, but a look at the "variance" columns shows that actual costs for some labor and materials items are higher than estimated, while others are lower. (The two variance columns show the same data, one in dollars and one in percents. A figure of -41% in the percent variance column means that your actual expense was 41% below your estimate.) The author advises that any discrepancies between estimated and actual costs should be looked at and explained as part of a weekly job cost review, to provide a check on complete record keeping and to help improve the accuracy of estimating.

Remodeling Company, Inc.
Income Statement

1 Month Ended July 31, 2001

Income	$32,408	100.0%
NET INCOME	32,408	100.0%
Cost of Goods Sold		
Materials	22,627	69.8%
Small tools and supplies	(413)	-1.3%
Subcontracted work	7,773	24.0%
Direct labor	9,669	29.8%
Payroll taxes	2,268	7.0%
Permits and licenses	2,580	8.0%
Vehicle expense	890	2.7%
TOTAL Cost of Goods Sold	45,394	140.1%
GROSS PROFIT	(12,986)	-40.1%
Expenses		
Advertising	351	1.1%
Dues and subscriptions	2,978	9.2%
Insurance–health	3,548	10.9%
Professional fees	914	2.8%
Meals and entertainment	62	0.2%
Officer salaries	4,000	12.3%
Payroll taxes–admin	306	0.9%
Scavenger	527	1.6%
Telephone expense	99	0.3%
Miscellaneous expense	5,964	18.4%
Rent expense	1,200	3.7%
TOTAL Expenses	19,949	61.6%
NET PROFIT	($32,935)	-101.6%

Remodeling Company, Inc.
Income Statement

1 Month Ended August 31, 2001

Income	$102,980	105.0%
Sales Adjustments	(4,925)	-5.0%
NET INCOME	98,055	100.0%
Cost of Goods Sold		
Materials	32,536	33.2%
Small tools and supplies	1,555	1.6%
Subcontracted work	7,810	8.0%
Direct labor	12,507	12.8%
Payroll taxes	961	1.0%
Vehicle expense	965	1.0%
Equipment rental	84	0.1%
TOTAL Cost of Goods Sold	56,418	57.5%
GROSS PROFIT	41,637	42.5%
Expenses		
Computer expense	52	0.1%
Dues and subscriptions	100	0.1%
Insurance–general	795	0.8%
Insurance–health	1,609	1.6%
Meals and entertainment	1,199	1.2%
Office supplies	15	0.0%
Officer salaries	3,200	3.3%
Payroll taxes–admin	245	0.2%
Scavenger	140	0.1%
Telephone expense	491	0.5%
Miscellaneous expense	6,130	6.3%
Rent expense	1,200	1.2%
TOTAL Expenses	15,176	15.5%
NET PROFIT	$26,461	27.0%

Remodeling Company, Inc.
Income Statement

1 Month Ended September 30, 2001

Income	$73,324	99.4%
Sales Adjustments	469	0.6%
NET INCOME	73,793	100.0%
Cost of Goods Sold		
Materials	38,768	52.5%
Small tools and supplies	2,349	3.2%
Subcontracted work	9,171	12.4%
Direct labor	8,640	11.7%
Payroll taxes	661	0.9%
Vehicle expense	990	1.3%
TOTAL Cost of Goods Sold	60,579	82.1%
GROSS PROFIT	13,213	17.9%
Expenses		
Advertising	384	0.5%
Insurance–general	3,082	4.2%
Insurance–health	1,717	2.3%
Professional fees	1,870	2.5%
Meals and entertainment	495	0.7%
Office supplies	15	0.0%
Postage	142	0.2%
Officer salaries	3,200	4.3%
Payroll taxes–admin	245	0.3%
Scavenger	279	0.4%
Telephone expense	38	0.1%
Vehicle expense	1,101	1.5%
Miscellaneous expense	1,047	1.4%
Rent expense	1,200	1.6%
TOTAL Expenses	14,815	20.1%
NET PROFIT	($1,602)	-2.2%

Remodeling Company, Inc.
Balance Sheet
September 30, 2001

ASSETS	
Current Assets:	
Cash in bank–checking	$71,358
Cash in bank–savings	$1,114
Cash in money management	$105,043
Accounts receivable	$73,271
TOTAL Current Assets	$250,786
Fixed Assets:	
Automobiles	$27,513
Office equipment	$10,267
Leasehold improvements	$1,198
Accumulated depreciation	($30,591)
TOTAL Fixed Assets	$8,387
TOTAL ASSETS	$259,173
LIABILITIES	
Current Liabilities:	
Accounts payable	$62,978
Customer deposits	$33,397
Accrued Payroll Taxes:	
Accrued federal withholding	$3,593
Accrued state withholding	$3,962
Accrued unemployment taxes	$101
TOTAL Accrued Payroll Taxes	$7,657
TOTAL Current Liabilities	$111,688
TOTAL LIABILITIES	$111,688
CAPITAL	
Capital stock	$1,000
Retained earnings	$153,548
Year-to-date earnings	$595
TOTAL CAPITAL	$155,143
TOTAL LIABILITIES & CAPITAL	$266,831

Figure 4. Shown above is a set of three monthly income statements, for July, August, and September, with a balance sheet as of September 30. On the income statements, gross profits go up and down: minus (12,986) in July (-40.1%), 41,637 in August (42.5%), and 13,213 in September (17.9%). This reflects the payment schedule on jobs, not profitability at the job's end. But the balance sheet shows current assets well ahead of current liabilities ($250,786 to $111,688), with capital of $155,143 available. This company can afford to have months where outflows exceed inflows, because in the long run it has good profits and has stored up a good fund of capital. Maintaining that solid position requires pricing and managing jobs to hit profitability targets.
Note: Some figures have been automatically rounded by Excel.

exceeded estimates, while the labor costs were well below estimates. It could just be the record keeping: Maybe a door got mixed in with the window order, and maybe some of the labor time charged to doors on the time cards was actually used to install windows. Getting the story straight will help keep future estimates accurate.

The point is to analyze the report and figure out what lies behind the numbers. Apparent profits on a job will go up and down depending on the schedule of payments and billings; you can explain those variations. But if the job itself is going off track — costs are creeping up above what you projected, or production is lagging behind schedule — you have to figure out why and take steps to fix it. The more accurate and complete your job cost data, and the more carefully you examine it, the better you can control costs and boost profits.

For a construction company, a short-term income statement can be deceiving

Recently, a contractor client put one of his regular subs on his books as an employee, with taxes taken out and so forth. Then, over the next few jobs, we noticed that his actual margins on jobs were suddenly below what he was aiming for. His actual costs had begun to exceed his estimates.

We figured out that his cost for that individual's labor had gone up on the hourly basis, because the payroll taxes and insurance costs on that worker were now on the employer's books. The company was estimating jobs from a baseline that was no longer accurate.

If he hadn't been checking his job profits on every job, that contractor wouldn't have seen anything but a declining bank balance. As it was, we identified the source of the problem, and he adjusted his cost basis for marking up jobs.

Monthly tasks. The first big monthly item in the calendar is to reconcile your checkbook. You'll typically receive a bank statement by the 5th of the month. I give clients until the 10th to have their checking account reconciled. If they're having trouble figuring out how their accounting program does this task, I'm happy to walk them through it.

On a monthly basis, I also schedule in a date for paying bills. You should pay your bills just once or twice a month. The 15th is a good date. If possible you should cut paychecks every two weeks rather than weekly — it cuts all that paperwork in half.

I also mark down payroll tax deposit deadlines on my client's calendar. That's a monthly item for small and medium contractors: If you pay less than $50,000 in payroll taxes in a year, tax deposits are due on the 15th of every month. For employers who pay more than $50,000 annually, tax deposits are due the same week you make payroll, or early in the next week.

So by the 10th, your checkbook is balanced out, and by the 15th all your outstanding bills are paid, including tax deposits. Now comes the major monthly event: reviewing your financial data. From the 15th to the 21st, produce your financial reports and start to analyze them.

You've looked at specific jobs every Friday. Now you want to look at the effect of all these jobs together. Where does your company stand? Are your profits on track? Are your operating expenses covered? Are your receivables (money owed to you) ahead of your payables (money you owe)? And are you in good shape to handle next month's round of bills?

Working With the Data

You can size up your situation by looking at a handful of core reports: aged accounts payable, aged accounts receivable, a balance sheet, and an income statement (Figure 4). Taken together, these reports show you where you've just been and where you are right now; and they help you look forward to the next few months.

The income statement is the history of the period, be it last month, last quarter, or last year. It summarizes all the inflows and all the outflows for that time period — the events that created the situation shown on the balance sheet. The balance sheet shows all your assets (things you own, money in the bank, and money that is owed to you) next to all your liabilities (debt you're carrying and money you owe). That's a snapshot of right now. The aged payables and receivables are part of the balance sheet (receivables are an asset, and payables are a liability), but shown in more detail: They tell you not just how much is owed to you and how much you owe, but how long ago those bills were sent or received.

Let's look at the payables and receivables first. Have you got customers who owe you money from months ago? If so, there's a problem. You shouldn't keep doing work for someone who's not going to pay you. Or maybe there's a punch list you need to take care of so you can get that final payment. Don't let bills get too old — identify the problem and take steps to collect. The older the bill, the harder it is to get your money.

After sizing up your payables and receivables, take a close look at your latest monthly income statement. It shows the combined effect of all your job cost numbers and your expense

numbers for a given period. Your billings for the period are shown at the top, followed by your cost of jobs; the difference between them is your gross profit for the period. Next you'll see your operating expenses for that period; this is subtracted from your gross profit to show your net profit.

The key number I always focus on is gross profit percentage. You used your expense budget to set the profit rate you have to hit; the income statement helps you check whether you're hitting it.

But for a construction company, a short-term income statement can be deceiving. You're not like a gas station that has steady inflows and outflows. You may lay out big dollars on a job over several months, and not see your profit until you collect a final payment. So a monthly income statement could show a big loss or a big profit, because of the timing of the inflows and the outflows. If you're in the middle of a job, profits for the month may look low; if you just received a big payment, they may look high.

So the important thing is to compare the monthly or quarterly totals with the job cost numbers you've been looking at each week — the job numbers should track right through the income statement. It's okay to run a loss for short periods if you've planned for it. Just make sure you consider your balance sheet at the same time as your income statement: The balance sheet shows whether you have the assets to cover the outflows you're experiencing until the inflows come back around.

The main thing to check on the balance sheet is not cash — your bank account could drop overnight if you pay an outstanding bill. Instead, look at your "current ratio" — your cash and receivables, against your payables. Is your cash in the bank, plus the money people owe you, more than the money you owe? Bankers love to see a current ratio (also known as a "working capital ratio") of 1.5 or even 2 — meaning that your cash and receivables amount to double what you owe in the short term. For contractor clients, I consider 1.2 or 1.1 a good healthy position. In fact, if it's 1 or better — your current assets at least equal your current liabilities — you can sleep at night.

The difference in dollars between current assets and current liabilities is called working capital. If your business takes on jobs that run for many weeks or even months, you need a lot of working capital. You can be making a great profit on paper but run out of cash because you're waiting to collect. The example balance sheet in Figure 4 shows a company that has built up a capital fund of more than $150,000, allowing the company to take on jobs that take months to complete.

Building up your working capital is a continuing business goal. To do it, of course, you have to make profits. So let's take one more look at the income statement. Like job cost reports, the income statement should stimulate questions: How does your profit for this quarter compare with the same quarter of last year? If it's down, what's the reason? Are you making a lower rate of profit on a higher volume? Are certain costs going up? Do you need to adjust your estimating numbers?

Also, compare the profitability of individual jobs to the average profit rate for your company and apply those insights. Maybe your gross profit rate for the quarter is 35%, but you make 40% when you do decks, 30% when you do kitchens, and 15% when you do basements. If so, that's a clue: Stay away from basements.

Use the income statements and the job cost numbers to identify your profit sources and to adjust your mix of jobs. Start going after the kinds of jobs you make the best money on, and start pricing the low-margin jobs higher. If you don't land certain kinds of jobs when you price them at the profit you need to make, consider yourself lucky: You've avoided work that's only dragging your business down.

Stuart Lerman *is an accountant based in Bolingbrook, Ill.*