

## Looking Beyond the Bottom Line

by Leslie Shiner

**T**oo often, business owners will print a profit-and-loss statement (P&L, also called an income statement) and then look at just the bottom line — net profit. That's unfortunate, because there may be financial problems lurking below the surface, and the only way to uncover them is to review the numbers behind the statement.

Unlike a balance sheet, which shows what you own and owe at a single point in time, a P&L shows your income and expenses over a period of time. If you wanted to look at only net profit, you could create a P&L by subtracting all your expenses from all your income.

But most builders want to see more than a single number, so they prefer a specific type of P&L called a multistep income statement. In simple form it looks like this:

|                   |
|-------------------|
| Income            |
| – Direct Expenses |
| Gross Profit      |
| – Overhead        |
| Net Profit        |

### Direct Expense vs. Overhead

The calculation happens in multiple steps because you want to distinguish between two kinds of expense: direct expense, or cost of goods sold (COGS); and overhead, or administrative expense.

A direct expense is directly attributable to a specific job: If you didn't have that job, you wouldn't have the expense. Overhead expenses are the costs that your company would incur even if you didn't have any jobs. It's very important to separate these expenses, because they measure different things.

Direct expenses are considered to be "above the line," which means they fall above the gross-profit line. These

### Profit & Loss Statement For 8 Months Ended August 31, 2004

| Operating Income                    |                                |                   |                     |                |
|-------------------------------------|--------------------------------|-------------------|---------------------|----------------|
|                                     | Commercial Income              | \$147,523.00      |                     | 15.27%         |
|                                     | Residential Income             | <u>818,854.83</u> |                     | 84.73%         |
|                                     | <b>Total Operating Income:</b> |                   | <b>\$966,377.83</b> | <b>100.00%</b> |
| Direct Expense (Cost of Goods Sold) |                                |                   |                     |                |
|                                     | Materials                      | 222,975.07        |                     | 23.07%         |
|                                     | Direct Labor                   | 150,130.33        |                     | 15.54%         |
|                                     | D/L Payroll Taxes              | 14,989.76         |                     | 1.55%          |
|                                     | D/L Workers' Comp              | 19,082.17         |                     | 1.97%          |
|                                     | D/L Liability Insurance        | 13,517.00         |                     | 1.40%          |
|                                     | D/L Small Tools                | 4,617.00          |                     | 0.48%          |
|                                     | Subcontractors                 | 217,178.61        |                     | 22.47%         |
|                                     | Engineering and Architects     | 5,580.00          |                     | 0.58%          |
|                                     | Equipment Rental               | 4,546.54          |                     | 0.47%          |
|                                     | Permits & Licensing            | <u>8,834.53</u>   |                     | 0.91%          |
|                                     | <b>Total Direct Expense:</b>   |                   | <b>661,451.01</b>   | <b>68.45%</b>  |
|                                     | <b>Gross Profit:</b>           |                   | <b>304,926.82</b>   | <b>31.55%</b>  |
| Overhead Expense                    |                                |                   |                     |                |
|                                     | Advertising & Promotion        | 4,746.90          |                     | 0.49%          |
|                                     | Office Payroll                 | 74,221.60         |                     | 7.68%          |
|                                     | Office Payroll Taxes           | 7,390.13          |                     | 0.76%          |
|                                     | Office Workers' Comp           | 1,372.65          |                     | 0.14%          |
|                                     | Interest/Bank Charges          | 4,264.35          |                     | 0.44%          |
|                                     | Dues/Subscriptions             | 1,587.73          |                     | 0.16%          |
|                                     | O/H Vehicle Expense & Ins.     | 12,158.57         |                     | 1.26%          |
|                                     | Insurance/General              | 5,664.50          |                     | 0.59%          |
|                                     | Rent                           | 26,400.00         |                     | 2.73%          |
|                                     | Phone and Communications       | 9,702.85          |                     | 1.00%          |
|                                     | Utilities                      | 3,787.94          |                     | 0.39%          |
|                                     | Office Expense                 | 6,616.84          |                     | 0.68%          |
|                                     | Depreciation                   | 5,000.00          |                     | 0.52%          |
|                                     | Administration Salary Owner    | 60,000.00         |                     | 6.21%          |
|                                     | Admin. Payroll Taxes           | <u>4,562.26</u>   |                     | 0.47%          |
|                                     | <b>Total Overhead Expense:</b> |                   | <b>227,476.32</b>   | <b>23.54%</b>  |
|                                     | <b>Net Income:</b>             |                   | <b>\$77,450.50</b>  | <b>8.01%</b>   |

In standard accounting, direct expenses (costs attributable to particular jobs) are "above the line" — the gross-profit line. Overhead expenses fall below the line, and affect total net profit. For accurate accounting, as well as accurate estimating, it's important to be consistent over time in how you code your expenses.

expenses should correspond to the items in the estimates or budgets for your jobs. When you do the books, it's critical to include these costs above the line. It's been my experience, however, that many contractors routinely charge direct-cost items to overhead categories. This is not a minor accounting issue — it's a practice that leads people to underestimate jobs.

For example, I've known contractors who used their burdened labor costs (gross wages plus workers' comp, employer taxes, and benefits) in estimates. But when they did the accounting, they

would code gross wages above the line and turn the added labor costs into overhead by coding them below the line. This doesn't affect net profit, but it creates a misleading P&L statement, one that understates direct job costs and overstates overhead.

The contractor might look at the inflated gross-profit number and think the estimate was accurate and that things were going well in the field. He might see the high overhead number and decide that he needed to cut overhead or boost volume. It might not hurt to cut overhead, but the contrac-

tor is making a mistake if he lands more jobs based on an unrealistic idea about how much gross profit he is currently making.

Labor burden is not the only expense that can be mistakenly carried as overhead. Premiums for liability insurance are typically related to total payroll costs or sales volume. If you do more work, you pay higher premiums, so the extra cost should be charged above the line. The same could be true for such expenses as mileage, cell-phone charges, and job-site supervision expenses.

## The Building Company Trended Profit & Loss January through December 2004

*(continued on next page)*

|                           | Jan-04              | Feb-04              | Mar-04              | Apr-04            | May-04            | Jun-04            |
|---------------------------|---------------------|---------------------|---------------------|-------------------|-------------------|-------------------|
| <b>Income</b>             |                     |                     |                     |                   |                   |                   |
| Job Income                | \$18,469.66         | \$16,658.22         | \$17,720.35         | \$23,726.80       | \$32,717.12       | \$41,677.09       |
| <b>Total Income</b>       | <b>18,469.66</b>    | <b>16,658.22</b>    | <b>17,720.35</b>    | <b>23,726.80</b>  | <b>32,717.12</b>  | <b>41,677.09</b>  |
| <b>Cost of Goods Sold</b> |                     |                     |                     |                   |                   |                   |
| Materials                 | 4,264.17            | 3,955.75            | 4,713.80            | 8,001.89          | 5,609.35          | 6,937.00          |
| Subcontracts              | 10,554.03           | 9,630.05            | 8,929.10            | 10,785.15         | 18,781.38         | 22,761.40         |
| Other Job Costs           | 0.00                | 0.00                | 0.00                | 248.57            | 0.00              | 0.00              |
| <b>Total COGS</b>         | <b>14,818.20</b>    | <b>13,585.80</b>    | <b>13,642.90</b>    | <b>19,035.61</b>  | <b>24,390.72</b>  | <b>29,698.40</b>  |
| <b>Gross Profit</b>       | <b>3,651.47</b>     | <b>3,072.42</b>     | <b>4,077.45</b>     | <b>4,691.19</b>   | <b>8,326.40</b>   | <b>11,978.69</b>  |
| <b>Expense</b>            |                     |                     |                     |                   |                   |                   |
| Rent                      | 0.00                | 300.00              | 300.00              | 300.00            | 300.00            | 300.00            |
| Insurance-General         | 0.00                | 0.00                | 243.84              | 0.00              | 15.89             | 0.00              |
| Office                    | 0.00                | 125.46              | 0.00                | 0.00              | 0.00              | 0.00              |
| Utilities & Phone         | 499.63              | 142.42              | 518.80              | 164.68            | 150.97            | 337.96            |
| Accounting                | 0.00                | 0.00                | 0.00                | 734.50            | 0.00              | 0.00              |
| Owner's Salary            | 4,000.00            | 4,000.00            | 4,000.00            | 4,000.00          | 4,000.00          | 4,000.00          |
| Dues & Subscriptions      | 0.00                | 0.00                | 0.00                | 0.00              | 0.00              | 0.00              |
| Taxes & Licenses          | 0.00                | 0.00                | 0.00                | 184.50            | 0.00              | 0.00              |
| Interest                  | 67.33               | 0.00                | 0.00                | 0.00              | 0.00              | 0.00              |
| Tools                     | 0.00                | 0.00                | 0.00                | 0.00              | 0.00              | 0.00              |
| Service Charge            | 208.00              | 15.60               | 48.10               | 15.60             | 15.60             | 15.60             |
| Vehicle Expense           | 239.20              | 13.00               | 405.03              | 0.00              | 7.49              | 0.00              |
| Advertising               | 0.00                | 0.00                | 0.00                | 0.00              | 650.00            | 0.00              |
| <b>Total Expense</b>      | <b>5,014.16</b>     | <b>4,596.48</b>     | <b>5,515.77</b>     | <b>5,399.28</b>   | <b>5,139.94</b>   | <b>4,653.56</b>   |
| <b>Net Income</b>         | <b>(\$1,362.69)</b> | <b>(\$1,524.06)</b> | <b>(\$1,438.32)</b> | <b>(\$708.09)</b> | <b>\$3,186.45</b> | <b>\$7,325.13</b> |

## Making Sense of Your P&L

The gross profit on your P&L is a combination of all the gross profits of all the jobs in a given time frame. Reviewing the gross profit will help you manage your jobs and determine if they are making the profit you expected.

Because jobs vary by size, it's easier to compare gross profits as percentages (gross profit/contract price = gross-profit percentage). You can compute the gross-profit percentage by individual job or for the entire company. Net profit is what's left after overhead, so you can compute that only for the

company as a whole (net profit/sales = net-profit percentage).

**Locating trouble spots.** If your P&L shows an amount lower than the gross profit you typically estimate, you need to dig deeper. Begin by comparing actual job costs to the amounts that were budgeted for those items. If the numbers are very far apart, it could mean you need to revise your estimating process, or do a better job managing production, or be more careful about the way you code expenses.

If you are losing money on jobs, you'll want to find out why. Is it because your

estimates are low, or your production processes are wrong, or your accounting methods are sloppy?

If you go over on labor, for example, is it because you spent more dollars or used more hours? If you used more hours, this might be either a production problem or an estimating problem. But if the work took the correct number of hours, then there is probably something wrong with the labor rate you used in the estimate. It could also be the case that poor scheduling forced you to pay overtime or that highly paid carpenters performed tasks that should have been

A trended P&L statement shows income and expense for a series of time periods — in this case, months. It doesn't change the year-end numbers, but breaks them down to make it easier to spot any trends.

|                           | Jul-04            | Aug-04            | Sep-04            | Oct-04            | Nov-04           | Dec-04            | TOTAL              |
|---------------------------|-------------------|-------------------|-------------------|-------------------|------------------|-------------------|--------------------|
| <b>Income</b>             |                   |                   |                   |                   |                  |                   |                    |
| Job Income                | \$46,234.60       | \$43,646.10       | \$43,038.51       | \$36,943.80       | \$29,388.11      | \$18,743.10       | \$368,963.47       |
| <b>Total Income</b>       | <b>46,234.60</b>  | <b>43,646.10</b>  | <b>43,038.51</b>  | <b>36,943.80</b>  | <b>29,388.11</b> | <b>18,743.10</b>  | <b>368,963.47</b>  |
| <b>Cost of Goods Sold</b> |                   |                   |                   |                   |                  |                   |                    |
| Materials                 | 11,485.83         | 3,553.75          | 7,445.52          | 4,559.88          | 8,594.07         | 2,459.50          | 71,580.48          |
| Subcontracts              | 22,083.75         | 27,355.92         | 23,156.67         | 21,842.70         | 14,846.42        | 11,416.68         | 202,143.24         |
| Other Job Costs           | 0.00              | 90.40             | 106.60            | 0.00              | 0.00             | 123.50            | 569.08             |
| <b>Total COGS</b>         | <b>33,569.57</b>  | <b>31,000.07</b>  | <b>30,708.79</b>  | <b>26,402.58</b>  | <b>23,440.49</b> | <b>13,999.67</b>  | <b>274,292.79</b>  |
| <b>Gross Profit</b>       | <b>12,665.03</b>  | <b>12,646.03</b>  | <b>12,329.72</b>  | <b>10,541.22</b>  | <b>5,947.63</b>  | <b>4,743.43</b>   | <b>94,670.68</b>   |
| <b>Expense</b>            |                   |                   |                   |                   |                  |                   |                    |
| Rent                      | 300.00            | 300.00            | 300.00            | 300.00            | 300.00           | 600.00            | 3,600.00           |
| Insurance-General         | 0.00              | 128.66            | 0.00              | 257.32            | 818.18           | 213.47            | 1,677.36           |
| Office                    | 0.00              | 0.00              | 62.40             | 62.40             | 0.00             | 0.00              | 250.26             |
| Utilities & Phone         | 369.38            | 461.89            | 309.43            | 316.19            | 234.44           | 176.38            | 3,682.17           |
| Accounting                | 0.00              | 0.00              | 0.00              | 0.00              | 0.00             | 0.00              | 734.50             |
| Owner's Salary            | 4,000.00          | 4,000.00          | 4,000.00          | 4,000.00          | 4,000.00         | 4,000.00          | 48,000.00          |
| Dues & Subscriptions      | 0.00              | 0.00              | 202.80            | 0.00              | 390.00           | 39.00             | 631.80             |
| Taxes & Licenses          | 0.00              | 0.00              | 0.00              | 0.00              | 0.00             | 0.00              | 184.50             |
| Interest                  | 0.00              | 228.63            | 0.00              | 118.05            | 71.55            | 77.55             | 563.11             |
| Tools                     | 0.00              | 45.50             | 292.50            | 0.00              | 0.00             | 0.00              | 338.00             |
| Service Charge            | 15.60             | 50.70             | 22.10             | 79.30             | 131.30           | 22.10             | 639.60             |
| Vehicle Expense           | 0.00              | 0.00              | 148.45            | 89.70             | 37.28            | 45.50             | 985.65             |
| Advertising               | 0.00              | 0.00              | 0.00              | 0.00              | 0.00             | 130.00            | 780.00             |
| <b>Total Expense</b>      | <b>4,684.98</b>   | <b>5,215.38</b>   | <b>5,337.67</b>   | <b>5,222.96</b>   | <b>5,982.76</b>  | <b>5,304.00</b>   | <b>62,066.95</b>   |
| <b>Net Income</b>         | <b>\$7,980.05</b> | <b>\$7,430.65</b> | <b>\$6,992.05</b> | <b>\$5,318.26</b> | <b>(\$35.13)</b> | <b>(\$560.57)</b> | <b>\$32,603.72</b> |

done by laborers. Looked at carefully, the P&L can tell you that a problem exists, but it's up to you to determine just what the problem is.

### Creating a Trended P&L

A P&L statement covers activity for a set period of time. You can create a P&L for a month, a quarter, a year, or any other interval you want. It's useful to compare activity across several time periods, which you can do by issuing a trended P&L statement, which shows each month in a separate column. That way, if there is a trend in your profitability, you can easily see it.

This works best if you keep your books on an accrual basis (see "Accrual vs. Cash Accounting," 10/04). With cash accounting, profitability will nearly always appear to fluctuate, due to the random timing of income and expense. Accrual gives you a truer picture of profitability because it matches income and expense to the activities that create them.

**Spotting trends.** When business is going smoothly, gross- and net-profit percentages will not vary that much

from month to month. If the trended P&L shows those percentages going up and down, it may mean that you are not being consistent in your accounting — perhaps the bookkeeper accidentally charged a direct expense to an overhead category, for example. Or profitability may be fluctuating because of unpredictable overhead, large warranty costs for completed jobs, or other unexpected expenses or income. As a business owner, you need to consider all the possibilities and then figure out exactly what is going on.

I recommend using a rolling trended statement, which would include information for each of the last 12 months. Each month, you add data for the month gone by and remove the month from one year ago. That way, there is data from every month of the year, which is important when you work in an area where construction activity is seasonal.

A builder in Maine, for instance, would not want to compare winter months to summer months. He's going to be more profitable in the summer, of course, when overhead expenses are

spread over a greater volume of work. But by comparing profitability in successive 12-month chunks of time, he can factor out seasonality and see the overall trend.

### Stay Current

Some contractors look at their P&L only once a year, usually as part of filing taxes. But a trended P&L keeps you focused on the most current months. You can easily lose sight of your business if you analyze statements just once a year. Those numbers quickly become stale as time goes by. Would you want to work with a lumberyard price list that is several months old?

If you issue a P&L regularly — say, every one to three months — and pay attention to what it says, it will help you detect problems before they harm your business. Even better, it can help you recognize your most profitable work and repeat it. 

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