BY MELANIE HODGDON

Nothing but Net

I'm always fascinated by the fact that more attention seems to be paid to gross profit than to net profit. For those of you who are still fuzzy on the difference, here's a quick review.

Total sales is the amount of money you collect for the projects you build (although some may call it "income" or "revenue" or "volume"). From this amount, two types of expenses must be paid. The first are type above-the-line expenses, which are also called "cost of goods sold" or "job costs." These include everything it takes for you to build out a project—materials, labor, subcontractors, equipment, and expenses for other items consumed by the work.

If you subtract what it costs you to build your jobs from what you charge for them, the result is called gross profit. From this amount, below-the-line expenses—also called "overhead"—are paid. These consist of all of the costs associated with running your business. When you subtract these costs of doing business from gross profit, the result is called net profit. That's the amount you have actually earned after all of the bills are paid.

CROSSING THE LINE

Now here's the interesting part. Suppose that Company A and Company B each sells $750,000 in a given year. If you could take a look at Company A's accounting setup, you would see that it has materials, subcontractors, wages, and payroll taxes posted above the line in cost of goods sold. However, health insurance and workers' comp costs are posted below the line in overhead expense accounts. By contrast, if you could look at Company B's accounting setup, you would see that while it, too, has materials, subcontractors, wages, and payroll taxes posted above the line, it has also included workers' comp, cellphones, and truck expenses in its job costs.

When it comes time to look at a profit-and-loss statement for each company (see table, below), it looks bad for Company B. Both companies spent a total of $675,000 running their businesses, but Company B appears to have a gross profit that is 13% lower than that of Company A. However, net profit for both companies is the same. The difference lies in the way that each company chose to distribute its job-related costs and business expenses.

While Company A's setup is fairly common, there is a certain logic to the way that Company B goes about its accounting. If workers' comp, cellphones, and truck expenses are all tied to having field employees, then those expenses wouldn't exist if the company didn't have a production crew. So it makes sense to include these labor-related costs above the line because they are directly related to the cost of building out the projects.

If you are trying to track your annual overhead figures in order to incorporate them into a reasonable markup figure, then ask yourself this: Where would I need to place accounts—such as cellphone, truck allowance, tool allowance, health benefits—that fluctuate with my labor force? If hiring or firing a worker significantly affects some associated accounts, it would make sense to isolate these accounts from your overhead in order to increase its year-to-year stability.

If you are concerned about how well your business is doing when compared with similar companies, keep in mind that your gross profit figures may be significantly different, but that doesn't necessarily mean that your company is in trouble. By focusing on your bottom line numbers, you will have a better overall indicator of how your business is performing.

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Looking only at gross profit, this simple P&L would seem to spell trouble for Company B, which is lagging well behind Company A. But net profit is the same for both. The difference lies in how they each account for job costs and overhead.

	Company A	Company B
Total sales	$750,000	$750,000
Cost of sales	450,000	575,000
Gross profit	(40%) 300,000	(27%) 175,000
Overhead expenses	225,000	100,000
Net profit	(10%) 75,000	(10%) 75,000

Why Use a 'Time Is of the Essence' Provision?

BY ALEXANDER BARTHET

Timing is everything, especially if there is a "time is of the essence" provision in your contract.

Most people enter into a contract with the understanding that performance will occur within a specific time frame. When performance is delayed, people tend to look to the terms of the contract for recourse. And if they find specific language making it clear that time does matter—that "time is of the essence"—then delayed performance of the particular or general contract terms will likely result in a material breach of the contract. This essentially allows the non-breaching party to terminate the contract.

In a subcontract, for example, the general contractor may specify a completion date and include the "time is of the essence" provision. If the subcontractor does not complete his work on or before the completion date, the general contractor may choose to terminate the subcontract, hire another subcontractor to complete the job, and sue the original subcontractor for breach of contract.

If a contract doesn't include such a "time is of the essence" provision, a delay will not be considered a material breach so long as performance is effectuated within a reasonable time. Even a "time is of the essence" provision can be waived if the parties continue their dealings regardless of late performance. In that case, courts will tend to not enforce termination of a contract. But be aware that simply granting extensions to perform will not necessarily constitute a waiver. In that instance, to preserve your "time is of the essence" provision, it's advisable that you grant extensions in writing expressly noting that the defaulting party is still in breach of the contract. In that way, when you've had enough of the delays, you can still choose to terminate the contract.

Be mindful of "time is of the essence" provisions—they're not just generic contract provisions but are useful tools to enforce performance dates.

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Take the Discount

BY SAL ALFANO

Most lumberyards offer a discount for early payment. It's usually described as "2% 10/net 30," which means that if you pay by the 10th of the month, you get a 2% discount; if you pay between the 11th and the 30th, you pay the full amount. (If you pay after that, you may pay penalties and interest.) In a session at this year's JLC Live conference in Providence, R.I., Leslie Shiner, owner of The Shiner Group (shinergroup.com), a small business consulting and training company based in California, explained that this amounts to a 2% discount for 20 days. Here's how she thinks about it.

Imagine that you've deposited $100 in a bank account and, after 20 days, you have $102. You take the $2 and put it in a cookie jar (to keep things simple, we'll ignore compound interest). After 20 more days the $100 you left in the bank account has again grown to $102, and again you put $2 in the cookie jar, which now holds $4. If you do this over and over again for the whole year, you will make 18.25 (365 ÷ 20) deposits in the cookie jar, for a total of $36.50 ($2 x 18.25). That's an annualized interest rate of 36.5% ($36.50 ÷ $100).

Shiner has another way of looking at it that involves solving the following algebra problem: 2% is to 20 as X% is to 365. Recalling our high school algebra, if we set the problem up as $X \div 365 = 2 \div 20$ **(1)**, then reduce the right side of the equation (2 ÷ 20) to 0.1, we are left with $X \div 365 = 0.1$ **(2)**. Multiplying both sides by 365, we get $X = 365 \times 0.1$ **(3)** or $X = 36.5$ **(4)**. As an annualized rate of interest, that's a pretty good deal.

1 $\frac{X}{365} = \frac{2}{20}$ **2** $\frac{X}{365} = 0.1$

3 $\frac{\cancel{365}\ X}{\cancel{365}} = 0.1 \times 365$ **4** $X = 36.5$

Sal Alfano is editor-in-chief of JLC. *To see a video whiteboard version of this and other Do the Math problems, visit his blog at jlcoonline.com.*