Sage Construction and Real Estate

10 Steps to Building a More Profitable Construction Business

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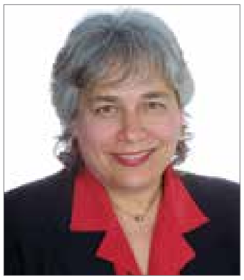
Introduction

10 Steps to Building a More Profitable Construction Business is a pragmatic approach to developing business practices that result in greater profitability. The lessons here apply whether you're a general contractor, builder or subcontractor working in residential, commercial, home building or any number of specialty construction trades. The 10 steps that follow are based upon the concept of the profit cycle—a complete, four-part cycle designed to help construction professionals learn from their mistakes and repeat their successes. As you will see, the goal is not to work more, but to work more effectively— and improve your company's bottom line as you go.

10 Steps to Building a More Profitable Construction Business contains strategies that can be used effectively in any number of ways. Ultimately, the key to success is the integration of every step within the profit cycle—yet substantial results can be realized by selecting and implementing only a few of these steps every month.

About the Author



Leslie Shiner has an MBA degree from U.C. Berkeley with an emphasis in Finance and Accounting. She has over 20 years experience providing financial management services to the construction industry. She leads construction accounting and project management seminars around the country and frequently speaks at national conferences. Leslie has served as an Adjunct Faculty member at Dominican University, San Rafael, CA. and at Sonoma State University.

STEP 1: Estimating for Profit

Creating a detailed, accurate estimate for the work you propose to do is the first step toward achieving real profitability—yet too many contractors fail to calculate the true cost of a proposed project based upon three essential elements: overhead, risk and job costs. Each of these elements must be reflected in the estimate ahead of time if you expect a profit once the job is completed:

Overhead. Understanding overhead is important. Think of overhead as the costs that would remain even if your crew didn't do any work for a week. You would still need to pay the bookkeeper, telephone, insurance, rent, and utilities—as an example.

Risk. It is important to include risk factors in each estimate—a "contingency" line—rather than just padding here and there. That way, you can measure your true costs against a real budget, as opposed to a padded one. Time and materials jobs have the least amount of risk while the bidding process for contract jobs includes the most.

Job Costs. Labor can be the riskiest and most difficult part of the estimating process. In order to prepare an accurate estimate, you must know how long each task will take and how much each task will cost—and that depends on the relative efficiency of your personnel. Without understanding the true productivity of your field staff, you cannot create accurate and reliable estimates.

Take Away…
It is important to remember that the mathematical difference between the budget and the bid is both overhead and profit. The goal of an accurate estimate is to determine your true costs–and offer you the ability to accurately assess the progress and profitability of each job against a pre-determined benchmark.

STEP 2: Managing Job Production for Profit

Once you're awarded a job, it's crucial to perform the work in the most cost-effective way possible if you expect to make a profit. While that may be easy in theory, it can be another matter altogether in practice. To effectively manage a job, keep these important factors in mind:

Change orders. Too many contractors lose money on change orders because they don't systematically track costs and don't take the time to bill for the change work they perform. Ironically, change orders can be an excellent source of additional profit because you have no competition for the work. In order to better track and manage change orders, you must create procedures to record changes in the field, turn those changes into work orders, and obtain signoff on approved work for billing purposes.

People productivity. As Ben Franklin said, "time is money," and it's especially true in construction. For example, if you run a job exactly as budgeted, but it took two weeks less to complete than expected, you have added profit directly to your bottom line. Why? Because that job will carry two Keep everyone informed. Both employees and subcontractors need to know the job schedule. Subcontractors appreciate early notice of schedule changes and will be more willing to help you out.

Take Away…

Consider the familiar story of the $150 box of staples: if you run out of staples on a job site, the cost of those staples amounts to the purchase price of the staples PLUS the cost of the time wasted by the crew as they stop to look through all the trucks for them PLUS the hourly rate of the most expensive person on your crew who must be sent to the hardware store to buy them. And don't forget the stop for the coffee and donuts. By utilizing a schedule that includes a complete parts list by task, you'll have all the materials you need on the job each day—and will improve the likelihood of being profitable by eliminating unproductive downtime. weeks less overhead.

STEP 3: Accounting for Profit

True job cost accounting can increase your profitability by helping you understand the actual costs associated with each job. A proper accounting system needs to accomplish two things: one, effectively meet your daily accounting and bookkeeping needs and two, meet your specific requirements as a contractor. That means streamlined processing and an effective way to manage workers' compensation, liability insurance, bonding and other issues of concern to you.

Remember that an accurate construction accounting system must distinguish between overhead costs and direct job costs. You must also be able to systematically compare your budgeted costs to your actual job costs to measure estimating effectiveness, labor productivity and use of materials.

Assigning the right responsibilities to the right people will help make your accounting system work for you. To accurately assign costs to a job, your project manager needs to be the one who codes the bills. If left to your bookkeeping staff, they may assign costs incorrectly since they are not close to the actual construction work being done. The result is that any report that compares actual to budgeted costs by cost code will be inaccurate and therefore meaningless.

Purchase orders can also help keep your costs in order. Using purchase orders will ensure that the project manager codes expenses at the time of order, not the bookkeeper, when the bill is received. And without using a PO, you could end up paying more than your supply house originally quoted if they make a billing mistake. This could happen because your bookkeeper can't spot the overcharge without a PO showing what the correct price should have been.

Contractors spend too much time and energy on accounts payable—and without a workable system in place, the quantity of incoming invoices will overwhelm your office. Just as important, if you do not send receivable invoices in a timely fashion and fail to follow up on them, you'll quickly find you don't have the cash to take care of the bills.

Take Away

An effective accounting system will enable you to meet daily bookkeeping needs as well as address issues of special concern to contractors. And better management means better cash-flow—taking you a step closer to running a more profitable business.

STEP 4: Analyze for Profit

Many contractors make the mistake of thinking of each job as an independent project—with a start and a stop. As a result, they rarely take the time to analyze each job and assess the overall success of the business. If you think of your projects as circular rather than linear, you will find effective ways to reduce costs and increase profits.

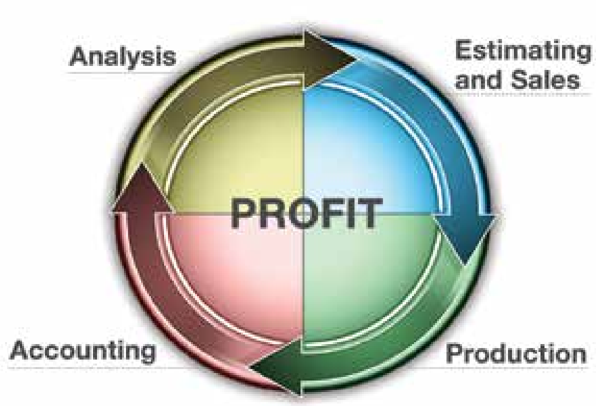
Contractors often have trouble ending jobs because they are more focused on starting the next one. Yet it's important to remember that you won't get paid until you successfully complete the project punch list—and the sooner you do, the sooner you'll receive payment on the final invoice, as well as the retention.

A thorough review should be built into your closing process. Look for unbilled amounts still outstanding from vendors. Look for unbilled change orders. Another important part of the review process is to compare your actual costs to your budget. Based upon what you learn, you can make needed adjustments, which will help you be more profitable on future jobs.

Take Away…
Each job is unique but it's important to remember that there are many similarities in every project you undertake, and that what you learn from each job can be applied to future jobs—insight that will help you be more profitable next time.

STEP 5: Understand the Profit cycle

Since we're half-way through the "10 Steps" let's review the construction business profit cycle again. Within the first 4 of our 10 Steps, there are multiple strategies to pursue. Decide which of them would provide the most ROI (return on investment) for your company and implement these.



Take Away…
Profitability depends on your ability to produce better business results in four different areas: 1) estimate more accurately, 2) finish jobs faster, 3) implement construction-specific accounting processes, and 4) refine job costing.

STEP 6: Define Goals and Set Expectations

You may wish to take some time to seriously consider and define your goals for your business. This will be your roadmap to follow. Once you've defined your own goals, then you're in a good position to guide your employees' and clients' expectations and behavior to serve your vision and theirs.

Define Goals. Really take some time to consider what you want to achieve in your business. Do you define success by your bottom line? By company growth? Spending more time with family? Here are some important things to keep in mind as you define success.

Too many companies define success in the short-term—an error that may ultimately damage your business. An emphasis on long-term planning and relationships over short-term gains will help ensure the ongoing success of your company.

We recommend some practical ways to define your goals that include use of a mission statement and complete business plans. Crafting a mission statement will help you systematically identify your values, your focus and what you hope to achieve. Business plans, on the other hand, require you to set realistic, detailed long-term management, financial and marketing goals and enable you to measure your success against them.

Set Expectations. Setting expectations will influence the behavior of your clients and your employees and result in more productive, long-term relationships. Consequently, you will be in a better position to achieve your own goals.

Clients. Repeat clients and referrals not only reduce your marketing expenses, but can dramatically increase your business volume and profitability. That's why it's so important to set expectations to influence your customer's view of your work.

Here are some important tips for setting expectations:

- Your clients need to know in advance that it's typical to have additional costs 10% to 25% more than the original contract from change orders. A client who has a realistic expectation of change orders and resulting costs will be far more willing to work with you during the job—and pay for the additional work you do.
- Don't forget to ask for referrals. Use your company signs at each job. Inform the neighbors that you'll be working in the area. Use each contact as an opportunity to do direct marketing for your business.
- Sometimes, as difficult as it is, you may need to fire a bad client. Miserable clients, who have unrealistic expectations, make for unsatisfactory and highly unprofitable jobs.

Employees. Your employees also need to know your goals and expectations. Employees who have shared goals will be more effective in performing their jobs. Sharing profits can go a long way toward creating shared vision and goals. Find out what makes each of your employees happy—better wages? increased responsibilities? fewer work hours?—and use that information as you work with them. Some employees are content to do the same job year in and year out. Others look for additional responsibility. Let your employees know what advancement path is available to them—and encourage them to succeed at it.

Employees are far more satisfied when they are held accountable for tasks they can control. Be clear about who is responsible for what, and then hold those individuals accountable. For example, it is difficult to make the bookkeeper responsible for coding invoices to the correct cost codes if he or she is not the project manager.

Take Away…

Each job is unique but it's important to remember that there are many similarities in every project you undertake, and that what you learn from each job can be applied to future jobs—insight that will help you be more profitable next time.

STEP 7: Create Performance Rewards

Money isn't the be-all and end-all of motivation…but it certainly helps! Creating performance rewards for your employees will motivate them to watch out for the bottom line. Here are three good ways to get started:

Setting profit-sharing goals based upon job responsibilities will help your employees feel in control over their contribution. Field personnel, for example, could be measured on job costs against budget, while office staff could be rewarded for decreased overhead costs.

Establish a range for bonuses. Setting a pre-determined percentage for all employees does not allow you to reward exemplary behavior. Employees will then have pocketbook feedback on how their work is viewed and evaluated.

Just because someone works really hard doesn't mean they are working well. We all know the person who stays late every night and works every weekend, yet never seems to get all the work done. Don't be fooled by effort—instead, look at each employee's results.

Take Away…

Be flexible in your approach to establishing employee performance awards. Make every reward proportionate to the results achieved—not the effort expended.

STEP 8: Train Good Staff

Good training can improve process and profitability, which is why it's crucial to remember that the right training is an investment, not an expense.

Why? Because replacing employees is expensive. Studies show that the costs associated with advertising, interviewing time and training can add up to almost half of that employee's annual wages. The bottom line? You want to keep good employees right where they are—working for you.

Education helps everyone. Encourage your employees to look for sources of training and learning opportunities.

It's also important that your employees understand the hidden costs of doing business. It's well worth the time it takes to educate them. They must understand that when you pay them $22/hr. and bill their services at $60/hr., you are not taking $38 dollars out of their pockets. Explain how an employer must pay workers' compensation (which can be $0.60 for every $1 in wages in some states), payroll taxes, half of FICA, social security, and health insurance for example. The more they know, the more satisfied they'll be.

Take Away…
Try to remember what you knew when you started out. If only someone had taught you all that you know now, success would have come that much sooner. It's the same with your employees; learning easier, more effective ways to do their work will increase job satisfaction and help you all work toward achieving the shared goal of profitability.

STEP 9: Create Written Procedures

Written procedures within a company are key to business profitability. Typically, companies create written procedures only after they lose money because something wasn't done right. The better way is to create written procedures ahead of time and avoid the failures altogether.

Written procedures will provide a roadmap to new employees on how and when to do their work. Defined procedures will save you time and money and will increase your profitability—not to mention save you training dollars. Consider these examples:

It only takes one instance of an incomplete lien release to understand how much money you can lose. Each state has different laws, and you must know the laws that affect you so that you can pass the knowledge along to your employees.

"Internal controls" is an accounting practice that can limit the risk of embezzlement. The bank statement must be opened by the owner. And someone other than the bookkeeper should reconcile the statement each month.

Since so much money is at risk on change orders, it is essential to have a good change order management procedure to ensure change orders are as profitable as they should be. Have written procedures for how each change order is started, completed and billed. Collecting time cards daily is essential to measuring your employees' productivity. Remember that a weekly time card due on Monday morning will typically be filled out all at once on Monday morning—and will probably not be accurate.

Create a system that tracks the expiration of your subcontractors' workers' compensation. Why? Because if you pay a sub without it, you will be held liable for those dollars. Consider the story of the contractor who verified liability coverage before the subcontractor started the job, but by the time it came to paying the sub, the policy had expired. The result: the contractor had to pay large sums of money to cover the sub.

Take Away…
Procedures can and should change and improve. They should be evaluated and reworked at regular intervals, at least every six months—and then be documented in a written form that will bring clarity to every business activity. Written procedures will help your business reduce risk, save money and be more profitable.

STEP 10: Communicate

On most projects, there are several groups with whom you need to maintain regular contact. Depending upon which group you fall into, these might be clients, general contractors or builders, subcontractors, employees, bonding agents, architects, engineers and inspectors. When you make communication with the various groups involved with your projects your top priority, you greatly increase the likelihood of having successful and profitable projects.

Communication with your employees, for example, is both valuable and necessary. Having regular staff meetings and recognizing and rewarding good work will help keep the lines of communication open. But be careful—you must also value your employees' time by making staff meetings both short and powerful. Remember, too, that employees will often assume the worst when they are not informed. Job security creates commitment among your employees, which in turn, can lead to greater profitability.

To improve communications with various parties outside of your company, you should develop a system for producing and documenting professional-looking reports and notices. Providing documented reports, including approved change orders, bonding reports, job cost summaries, subcontractor notices, and lien releases will provide clear communication and prevent against any misunderstandings long after the job is completed.

Take Away…
Good communication during a project with all parties involved may lead to strong relationships even after the project has ended and may frequently result in new referral business.

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