By Gerald Popovec and Henry Rossi

THE PROFITABLE CONTRACTOR

Profits in a construction company can usually be traced to management Here is an overview of some of the more important functions

Two wall and ceiling contractors with similar organizations and a common geographic marketplace were reviewed at the end of an identical fiscal year.

Each had done an annual volume of $1 million. However, the gross profit for one contractor was 6 percent—and for the other, 16 percent. The 10 percent spread in gross profit for these two companies accounted for a million dollars of profitability.

With all that their businesses had in common, what could have caused this difference in operating results? Was it happenstance, or can the difference in gross profit be traced to something more concrete?

Profitability performance in the construction industry can usually be traced to top management-to the philosophy and action policies of the chief executive officer. His ability to plan, to evaluate resources and capabilities (especially people), and to make prudent decisions will frequently be the key factor; it distinguishes the profitable contractor from one who is average, or even barely surviving.

Many subcontracting companies began as relatively small, family controlled businesses and the owner-managers personally monitor all operations. As the successful business grows, subordinates are hired to handle what the owner has been doing very well.

In too many instances, these individuals (estimators, superintendents, foremen, accounting clerks) have a limited knowledge of construction management. And, when an owner decides to let others carry out these functions, he fails to give his expanded business the management attention it needs.

The profitable contractor, on the other hand, recognizes that through business planning and budgeting he can attain a higher profit goal. He views this process as having values similar to plans and specifications in determining the course of action and anticipating problems in the building function.

Thus, this owner decides to let others carry out many functions but to give the expanded business the management attention it needs through a business plan—and through proper feedback against the plan.

From a functional point of view, managing any contracting business involves applying business planning to several basic activities; the estimate-bid process, the build function and control of job progress, control of overhead, cash management and taxes.

Even though these activities are fundamental to any construction company, it is *how* they are approached and accomplished that determines profitability. The following overview can provide some insight into the management techniques used by the profitable contractor.

Estimate-Bid Process

In terms of the estimate-bid process, what is the profitable contractor doing that the average or marginal subcontractor is not?

First, and most importantly, management maintains control over the estimate-bid process. Because sizeable gross dollars are involved, with relatively small profit dollars, an estimating mistake of minor proportions can create a loss that will surely be felt.

More contractors have been badly burned by mistakes in the estimate-bid function than in the construction process.

Because a cost estimate and bid must frequently be. assembled in a limited time period (weeks, days or even hours) adequate controls are needed.

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In contrast, should a mistake be made in the installation or construction process, more time is available to recognize and correct an error or minimize its harm. Accordingly, the owner must keep constant vigil over his employees and the factors involved in the estimating process. One such factor is the application of overhead to the estimate.

There are a number of ways overhead can be applied to an estimate. Four common methods are: average annual rate applied to job costs, average annual rate per hour of direct labor, lump sum based on management's judgement of the market, and variable (slider) rate of job costs.

Of these methods, the management judgement and slider approaches appear to have provided more profitable results when they are used consistently.

Management Judgement Method

The management judgement method depends on the profitable contractor's full understanding of the competitive marketplace in which he submits bids—as well as his first-hand knowledge of his company's current overhead commitment.

The slider approach is control oriented and based on the principle that as volume increases, overhead (as a percentage of volume) decreases. Percentages for this system are developed through either the company's historical data or geographic market data.

Either approach to the slider method is effectively used by profitable contractors because they are careful to prepare reasonable forecasts and control deficit overheads.

Obviously, management's full attention and review of the estimating process is needed to arrive at bids which compete effectively in the market and result in contracts.

Once a contract has been awarded and scheduled, manage-

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ment must monitor and control job progress. With more than one job underway, a contractor cannot give his full, on-site attention to any single project. Therefore, he will need accurate reports from the field to assess whether work is progressing according to plan.

What is the management approach to job progress and cost control that distinguishes the profitable contractor? At the top of the list is periodic, realistic and timely evaluation of percentage-of-completion and cost-to-complete for each job in process.

It is difficult to know where a job stands without also knowing the cost to complete. Using incurred costs alone would provide inadequate and incomplete information.

Systems Are Monitored

Traditional unit cost systems, or the newer trend of "budgeted hours per unit" coupled with a "buy-out" measurement, and changes in usage of materials, are carefully monitored by the profitable contractor. Wherever appropriate, adjustments are made to the project on a timely basis.

Knowing that it is difficult to collect on change orders or claims after a job is completed, the profitable contractor is certain to document and obtain authorization for payment in these areas before work is finished.

He insists on approval and/or payment for changes while the job is in progress. The changes that occur during the build activity are controlled as carefully as the original base contract. Finally, the owner continues to visit job sites regularly and, by his presence, makes sure the jobs go as they should.

Control of overhead can be a highly refined accounting function or a relatively simple process that provides management with exception reporting.

An effective overhead control procedure involves the preparation of overhead budgets as a means of monitoring how much is spent against what has been budgeted. The actual results are then compared monthly to the forecast.

Budgeting and reporting of actual cost enables the profitable contractor to seek—at the earliest possible time—an answer to the question, "Why have we overspent?"

In many cases, successful contractors do not borrow money and may often have temporary, excess cash available. How do they achieve this?

Such techniques can provide this extra cash: "front loading" the contract cost breakdown; timely billing and collection procedures; use of the "completed contract method of accounting" for income tax reporting.

Using the "front loading" technique the contractor will normally try to assign higher values to items that will be performed early in the job while reducing the value of items that will be performed in the later stages of the job. (However, a contractor uses this technique with caution because he would not want to damage his relationship with a client by unrealistically front loading the breakdown.)

And the contractor must choose the items with care. There is always the possibility of contract changes. A contractor will not want to give up too many profit dollars because of inflated or deflated prices in the cost breakdown that may be required as pricing for change orders.

Money Becomes Available

By using the completed-contract method of accounting, the contractor defers payment of income taxes at the end of the year on those jobs which have not been completed and accepted by that time. By deferring such tax payments, money is available for use in the business.

A successful combination of the above techniques can lead to, a cash excess that is temporarily freed for investment in short-term securities. Practices such as these can add additional earnings to the contractor's operations.

In addition to the accounting method consideration, the profitable contractor also avails himself of other tax planning advantages. Because he is profitable, terms such as executive compensation, fringe benefits and estate planning are of major importance. Proper disposition of these items make the profitable contractor a profitable individual. □