

# Making Sense Of the Numbers: Six Key Reports

**A**t Quality Electrical Services, an open-shop firm in Harrisburg, Pa., every other Monday is “reality-check” time. That’s when the company’s president, Dwayne Zimmerman, runs his detailed job cost reports, which compare accounting software cost records to project managers’ projected labor-complete task codes. A good Monday is when Quality Electric’s jobs are slightly ahead of what costs show. There is always that occasional job, however, when job cost numbers are higher than the estimated percent-complete.

“That’s when we go into panic mode,” Zimmerman says. “But the good news is that we can address the problem early. And it’s always better to address it in week three, rather than at the end of the job, because then you have time to turn it around.”

Zimmerman, whose company has grown from \$1 million to \$5.5 million in revenue since 2001, is similar to other construction executives. He runs a variety of financial reports, both standard and customized, on a regular basis. Why? “Because in about five minutes, I can see exactly where we are, where we are going and where we will be,” he says. “Thanks to good reporting, and an excellent project team that responds to these numbers out in the field, we don’t look back at the end of a job and wonder how we did,” he adds.

Construction executives like Zimmerman possess a kind of financial literacy that, for some, comes naturally but for others must be learned. With an eye on day-to-day job costs, as well as overhead expenses and cash flow, they influence their company’s financial success.

Unfortunately, not every contractor possesses the elusive financial-literacy gene. Far too many construction owners

and managers focus more on their trade than on their company’s finances. Without the ability to read financial reports, or extrapolate from those numbers, these executives have only a vague idea of where the company stands financially. No matter how exceptional their contracting skills may be, their businesses may have little chance of succeeding in the long term.

## THE MUST-HAVE, MUST-KNOW LIST

Construction companies are as varied and unique as their specialized trades and geographic locations. And though no two companies have quite the same financial reporting requirements, nearly every contracting business should produce, review and understand, at a minimum, six basic financial reports.

## THE STANDARDS

Just about every business in the world—from contractor to computer wholesaler—must produce and examine the two most important financial reports: the standard balance sheet and income statement. These two reports work in conjunction with one another to offer a snapshot view of the company’s financial position at a given point in time.

The balance sheet details three important areas:

- assets, which are valuable and tangible items owned by the company such as cash, equipment and land;
- liabilities, which are obligations owed to third-parties such as payable invoices, loans and payable taxes; and
- owner’s equity, which represents the claim the owners of the company have on its assets, including capital stock and retained earnings.

The balance is calculated for an as-of date, typically the end of a month, quarter or year, and shows the company’s financial status as of that date, taking all previous history into account.

The balance sheet is particularly useful when it is compared to previous balance sheets, because business changes will be visible. For example, a long-term and consistent increase in owner’s equity often indicates a profitable and stable company.

The income statement is also sometimes called a profit and loss statement because it details just that—a company’s revenues and expenses for a given range of time, typically a single month, quarter or year. (Unlike the balance sheet, it is not an “as-of” picture, but rather a reflection of just the activity within a particular period.)

The income statement typically shows revenues, followed by direct job costs and resulting gross profit. Many contractors look at the gross profit as an indication of their success or failure on the jobs worked during the period. However, this figure understates the real financial status of the organization.

The income statement goes on to detail indirect costs such as operating expenses, also known as overhead. This amount is subtracted from the gross profit to arrive at the net operating income, or the amount actually earned by the company during the indicated period. The net income or loss represented is transferred as an increase or decrease to the owner’s equity shown on the balance sheet, closely tying these two reports together.

## OVERHEAD ALLOCATION REPORTS

The income statement shows net profit for a period for the business as a whole, but it’s

also important to see this information for one job at a time, and overhead allocation reports serve this purpose.

Many contractors fail to do any overhead allocation, perhaps because there are so many methods that it becomes confusing. However, with the right accounting software, producing an overhead allocation report can be simple and pain-free. The key is to be consistent and to choose a method that is in-line with the business. For example, for labor-intensive contractors, it often makes the most sense to allocate based on labor. A company can allocate more overhead costs to jobs that incur more labor, resulting in more accurate prorating of indirect costs.

#### **PERCENT-COMPLETE REPORTS AND OVER/UNDER BILLING**

There are as many ways of determining percentage of completion as there are contractors. Many use the old scratch-of-the-chin method, where they take a tour of the jobsite, scratch their chins and come up with a reasonable number. Others look at the amount of costs posted for a job as compared to the estimated costs. Still others base completion on the units of materials used. Obviously, some methods are better than others.

Regardless, contractors should be confident in the implications of this figure—and that means looking at percent-complete reports, including an over/under billing report. In the over/under billing report, the percentage of completion of a job is compared to the amount currently billed to the customer. If the job is considered 25 percent complete, but 35 percent of the revised contract amount has been billed, the job is considered over-billed and a liability. Conversely, if only 15 percent has been billed, the job is under-billed and an asset.

The over/under billing report should be used in conjunction with a report that explains the background of percentage of completion. This can mean looking at a detailed job-costing report showing the revised budget compared to the actual costs in terms of dollars or units.

The job-costing report is essential for internal understanding of how the job is progressing. The over/under billing report, on the other hand, is often used by outside parties for bonding, loans, etc.

#### **CASH FLOW STATEMENT**

In the world of over/under billing, a job being over-billed is a liability. In the world of cash flow, however, over-billing is sometimes done purposefully in order to have access to much-needed cash. The key is striking a balance between accurate billing and the flow of cash.

A cash flow statement can help contractors understand the cash activity within a given period. The standard financial report compares the balance at the start of the period to the ending balance, and explains the various sources of cash (operations, selling assets, borrowing, etc.) as well as how the cash was used (accounts payable, payroll, loans, etc.).

Understanding and predicting cash flow is one of the most important areas of financial management. Companies with cash flow problems—profitable or not—are much more likely to experience financial trouble, or go out of business, than companies with healthy, ongoing cash flow.

#### **THE HARD TRUTH**

The truth is, many construction owners and executives manage to run their contracting companies without a thorough understanding of these financial reports. So is it really essential that the non-financial types use and understand all this information? The answer is: only if the executive hopes to lead a growing and prospering company. Handicapped by financial illiteracy, a business has virtually no chance of long-term survival if making money is not the first priority.

Fortunately, many tools can bring the financially challenged up to speed. Hiring an outside CPA firm with a focus on construction would be a good step, as well as evaluating all the processes and people who track and analyze the company's financials. In addition, many construction-specific accounting packages are on the market, greatly simplifying the complex world of construction accounting.

Ultimately, there is no real option except to use, understand and make sense of the numbers. What's at stake is nothing short of the company's financial health and direction.

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