



Financial Reporting:

What you need to know about the basic financial reports (Part 1 of 4)

A Financial Management Message

July 3, 2007

OK, so for the next few weeks we're back to financials. I know that this can be a little bit painful for some of you but you can't escape this part if you ever want to be as successful as you want to be.

Remember that by now, you should have your chart of accounts in the format we discussed a few management messages ago. If you haven't done so, you're falling a little bit behind. Call us and we can help you get caught up.



Every dollar that flows in and out of your business is recorded somewhere in a financial report. Each report is designed to tell you something specific about your business. When you begin to thoroughly understand basic financial reports, other reports will eventually begin to make intuitive sense.

The three reports fundamental to understanding what's going on in your business are:

1. The Income Statement (also known as the Operating Statement or Profit and Loss statement or Statement of Earnings)
2. The Balance Sheet
3. The Cash Flow Statement

All other reports support these three reports. Think of these basic reports as the foundation and all other financial and operational reports as the lumber and building products needed to build the walls and eventually trim-out the house.

Income Statement

The income statement is a statement for a builder's operation for a specific time period such as for the month, quarter, or year. Net income or loss for the period becomes part of the balance sheet by increasing (net income) or decreasing (net loss) the owner's capital. The income statement is a summary of the following:

Please click on the following link to download a sample income statement - www.smaconsulting.net/Sample_Income_Statement.pdf.

Revenue is broken into subcategories of different revenue types.

- custom building
- production building
- speculative building
- remodeling

Correlating Direct Costs are any costs that can be directly attributed to a specific job plus land, if applicable.

Gross Margin is any money left over after subtracting direct costs from the revenue.

Expenses are broken into subcategories.

- indirect costs
- sales and marketing expenses
- finance expenses
- general and administrative expenses

You need to begin getting used to looking at your income statement in what we call management accounting format. In management accounting, several things that GAAP and Tax say are direct cost, we do not want to put as a job cost.

We'll explain more about this later.

Net Income (earnings or loss) is any money left over after subtracting total expenses from the gross margin.

The first thing we need to analyze in any income statement is the amount and percentage of the costs of sales and the leftover gross margin. Get used to looking at income statements as a dollar amount and as a percentage amount. Understanding what both tell you is important.

Income Statement NOTE

Whenever we refer to percentages on an income statement, the percent is always calculated by dividing the component you want a percentage for by the total sales revenue.

Below is one example of how we use the income statement to help our clients quickly improve their business.

My numbers are low, where should I start?

Many builders spend a lot of time and effort worrying about overhead expenses, which are certainly important. However, if your gross margin is low (meaning below industry benchmarks that range from 18 to 30 percent, depending on builder type), very low (meaning barely above your operating expenses), or worse, below operating expenses, concentrate your efforts on improving gross margin. Here's why.

Let's say you build the same home 10 times each year with an average sales price of \$100,000. Total sales for the year would be \$1,000,000. Let's say that cost of sales (or direct costs) for each of those ten homes is exactly \$80,000 for a total cost of sales of \$800,000.

That leaves you with a gross margin of \$20,000 per home or a total gross margin of \$200,000. The gross margin percentage is 20 percent.

$$\frac{\text{gross margin of } \$200,000}{\text{total sales of } \$1,000,000} = 20 \text{ percent}$$

Let's also assume that operating expenses are exactly \$140,000 or 14 percent. That leaves us \$60,000 net profit before taxes or 6 percent net profit.

Now let's assume we have very limited time and resources, (remember, that's why we're not spending any time reviewing financials in the first place) and we only have one day to spare during the year to work on improving our operations. Our choice of how to spend that day is between reducing operating expenses by \$1,000 or reducing the direct costs of our one home plan by \$1,000 through value engineering. Which one would you choose?

I hope you said to reduce the direct costs of our home plan. Here's why.

If we choose to spend the time to reduce operating expenses by \$1,000, we'll have added \$1,000 to our bottom line or increased our net profit margin by .01 percent.

If we choose to spend the time to reduce the direct costs of our home plan by \$1,000, we'll have lowered our direct cost by \$1,000 times the 10 homes we built during the year. Our new direct costs will be \$790,000 and our new gross margin will be \$210,000. Subtract our operating expenses of \$140,000 and our new net profit margin is \$70,000 or 7 percent. We've added \$10,000 to the bottom line or an entire percent because of the multiplier effect.

GROSS MARGIN IS EVERYTHING in the homebuilding industry. If you are struggling to make your desired net profit, concentrate your efforts on improving your gross margin.

Some builders choose to debate us on this point but those that do are swimming up stream.

We'll discuss this in more detail next week.

Have a great week.
Mike

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