

BUDGETING FOR SUCCESS IN THE CONSTRUCTION BUSINESS

A Six-Step Plan for More Effective Budgeting

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Budgeting for Success in the Construction Business: A Six-Step Plan for More Effective Budgeting

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When your primary concern is simply holding on and surviving, it’s tempting to pay less attention to the routine fundamentals, such as preparing a realistic budget and following through on it. That’s been the situation in much of the construction industry in recent years.

In fact, difficult times make attention to the basics more important than ever – which means now is a good time for contractors and sub-contractors to take a fresh look at their budgeting practices.

Why a Solid Budget Matters Now More Than Ever

Why worry about budgeting when all that really matters is finding and getting work? One reason is that an up-to-date, credible budget is an essential requirement for preparing competitive, yet realistic bids.

At its most basic level, a contractor’s or subcontractor’s bid must take into account the estimated materials cost for the job, along with direct labor costs, plus the burden on that labor including payroll taxes, unemployment taxes, workers’ compensation insurance, and various employee benefits such as health insurance, profit-sharing, and holiday and vacation time. Finally, the contract must cover a portion of the business’s fixed overhead, plus a profit that is commensurate with the risk the business is incurring by agreeing to do the work.

That’s the theory. In reality, of course, it’s never that simple.

For example, both the burden on labor and fixed overhead numbers are generally determined using a fixed formula – a formula very likely to be out-of-date these days in view of the cost-cutting measures most contractors have taken in the past few years.

If you have made significant reductions in administrative overhead, or have trimmed benefits such as vacation time or profit-sharing contributions, the formulas you use to accommodate these costs in your bids could be outdated. The disciplines of the budgeting process can help you bring your cost structure up-to-date.

In this way, budgeting directly affects bidding – which in turn affects your margins and, ultimately, your ability to get work.

Step-by-Step Through the Budget Process

There are many effective approaches to developing a realistic operating budget, and most businesses will fine-tune their specific budgeting practices over the years. While each situation is unique, here are six basic steps a contracting or subcontracting business should follow as part of its standard budget discipline:

Step 1: Assemble Your Budget Team

Your budget should not be developed in isolation – it’s a team effort. In a closely held business or partnership, the business owner or owners obviously take the



lead; in a larger corporate structure board members or a board committee may oversee the process. Beyond these leaders, though, other key members of management, administrative and operational teams also have useful contributions to make:

- The controller or CFO is a key player throughout the budgeting process. He or she will understand the company's overall cost structure better than almost anyone else.
- Project managers should be consulted during the process. While you may choose not to involve them in actually developing the budget, they can provide valuable input since they have first-hand understanding of the existing backlog and the gross profit it is likely to generate.
- Experienced estimators can also offer valuable input. They are on the front line in your campaign to get more work, and can provide useful insights into the competitive nature of the market and what margins can be reasonably expected.

Step 2: Be Sure Your Accounting Systems Are Up to the Task

The ultimate value of the budget as a management tool is the ability it gives you to respond promptly whenever conditions vary from your projections. In order for that to work, however, you need solid accounting systems that provide accurate, up-to-date information on a timely basis. The sooner you identify variances from your plan, the sooner you can make any needed course corrections.

Working closely with your accountant, review your financial systems to be sure all revenues and expenses are recorded promptly and accurately to the appropriate accounts and all information is reported to you on a timely basis. At the end of the year you must have a detailed, accurate and understandable historical record so you can look to the coming months with precision.

Step 3: Get an Updated Picture of Costs

With the team and accounting systems in place, it's time to get started in the actual budgeting process, beginning with a full and clear understanding of your cost structure.

As mentioned earlier, this is especially important during times of significant changes in the market, such as those that have occurred in recent years. These rapidly changing market conditions mean your costs have probably changed significantly as well.

Begin by reviewing all cost-cutting actions you have taken in recent years, then recalculate your fixed overhead costs such as office rent, utilities, salaries, and other general and administrative costs, along with depreciation and other fixed expenses that are not chargeable to specific projects.

Once you have determined this updated fixed cost structure, project it out over the course of a year. This number represents the minimum amount you must net after materials, labor and other cost of sales. It will form the basis for the rest of your budget calculations.



Step 4: Develop a Revenue-Driven Budget

With your minimum fixed operating costs mapped out, the next step is to review your historical revenue patterns and, based on current backlog and market conditions, develop a realistic projection for the next 12 months. Here is where input from project managers and estimators is especially useful.

Next, estimate how much margin you can expect on your projected sales. Remember that a changing market means your historical formulas may no longer be indicative of the gross margin you can expect over the coming year. Consider the nature of jobs in your backlog today, and your reasonable expectations of what types of jobs the market will generate in the coming months.

Pay particular attention to your estimated labor costs. Based on revenue projections and historical performance, determine how much work you can handle and how many people will be needed to generate your revenue target. Many contractors find it useful to develop a dollar-per-employee-hour estimate, and use this metric as a guide to be sure the company is right-sized to meet its expected overhead costs.

Finally, using a conservative margin estimate, compare projected net revenues with projected fixed costs to determine if you will cover your overhead. If the answer is “no” you have only a few alternatives: you can look for some way to increase revenues, take additional cost-saving steps, or raise additional working capital – either through equity or borrowing – to maintain cash flow and keep you operating until conditions improve.

On the other hand, even if the answer is “yes,” bear in mind that no one ever hits their budget precisely. To avoid making difficult decisions under pressure, develop a game plan that spells out exactly how you would respond under various scenarios – say, if revenues fall short by 10, 15 or 20 percent, or if margins are less than projected.

Depending on your size and management philosophy, you may want to let everyone see the projections and the plans you have in place for cost reduction so no one is caught by surprise if belt-tightening becomes necessary. Even if you choose not to share your plan, it is important to have the plan in place early – before things go awry – so you can plan your response rationally without emotion or pressure.

Step 5: Develop a Profit-Driven Budget

The cost-based budgeting process we just described could be called a “top down” approach. You start with your top-line revenue projections and develop your budget to determine how much bottom-line profit will remain after you meet overhead.

Now it’s time to take an alternative, “bottom up” approach. Begin by identifying the bottom-line profit you want to make and then add your fixed overhead. Divide this total by a reasonable estimate of your gross profit percentage. The result will tell you how much total revenue you must generate to produce the desired profit.



Each of these approaches serves as a valuable reality check on the other. If there's a significant disparity between the two, determine why they differ and make adjustments as necessary to produce a realistic, objective budget.

Step 6: Monitor and Respond

Finally, once your budget is in place, monitor all key metrics closely – ideally monthly – to determine where you are and what steps to take to either increase revenues or trim costs further. Unfortunately, this is an area where many contractors drop the ball.

Regular monitoring and timely comparison of your actual performance against budget are essential. Having a rational, well-thought-out response plan is of little value if you put off your budget review so long that any response is too little, too late. Every day you delay your review is another lost day of reaction time.

The process of developing and refining your company's operating budget is a valuable exercise. It strengthens your management team by making them more sensitive to your cost structure and more familiar with what drives profitability.

But the budget's real value is its use as a management tool. Having a practical, effective budget – and then managing your business to meet that budget – will help you navigate more effectively through the challenges that construction-related businesses will continue to face in the coming years.



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Jay's background in tax compliance and research helps him provide insight to his clients across a broad spectrum of financial issues. He has additional expertise in accounting and auditing based on the years he has spent supervising audit and review engagements. His clients rely on his strategic business counsel.

Jay works with clients in numerous industries, including manufacturing, construction/real estate, distribution and services. He is also a key member of the firm's employee benefit plan audit team.

Prior to joining Barnes Dennig, Jay worked for a large, international accounting firm in their tax practice. His experience ranges from working with a local technology company to develop a business plan for marketing a new software product to operating as an outsourced CFO for a large local contractor.

Jay has been quoted as an authority on audit and accounting matters in the *Business Courier* and several industry trade group newsletters, and he is a regularly featured speaker at trade group meetings. In addition to his professional affiliations, Jay served as the Treasurer for the Cincinnati-Kharkiv Sister City Project, the Cincinnati bid to land the 2012 Olympics and as Treasurer and board member for Easter Seals of Southwestern Cincinnati.

Jay graduated from Miami University with a BS in Accountancy. He earned an MBA, with a concentration in finance, from Xavier University. He is a member of the Ohio Society of Certified Public Accountants (OSCPA) and the American Institute of Certified Public Accountants (AICPA).

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